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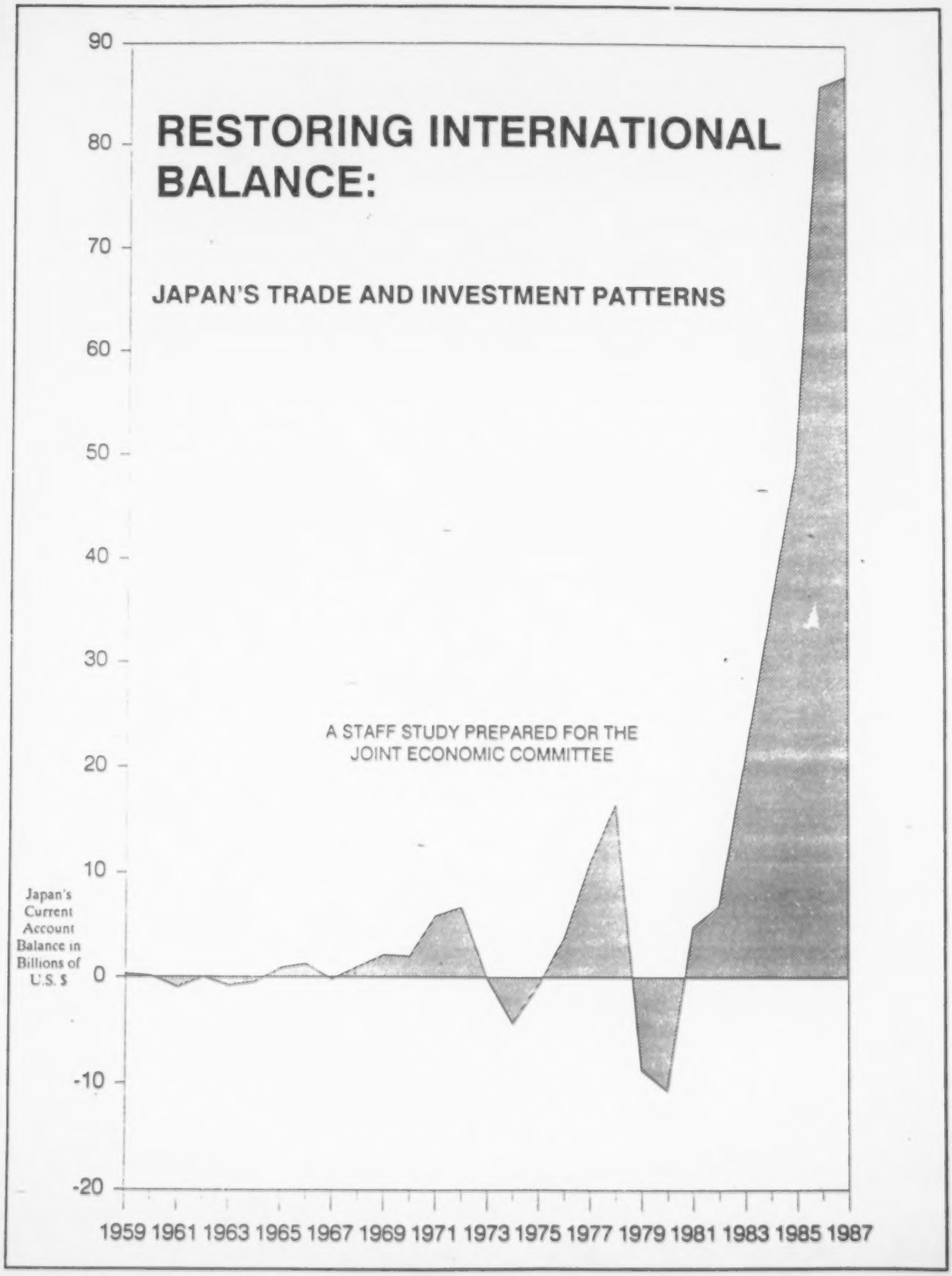
RESTORING INTERNATIONAL BALANCE:
JAPAN'S TRADE AND INVESTMENT PATTERNS
A STAFF STUDY PREPARED FOR THE JOINT ECONOMIC COMMITTEE
Japan's Current Account Balance in Billions of U.S. $
90
80
70
60
50
40
30
20
10
0
-10
-20
1959 1961 1963 1965 1967 1969 1971 1973 1975 1977 1979 1981 1983 1985 1987

J842-11

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July 1, 1988

To Members of the Joint Economic Committee:

I am pleased to transmit to you the third in a series of studies by Joint Economic Committee staff members which focus on the trade surplus phenomenon, and the problems which today's unprecedented trade surpluses pose for the world trading system and, over time, for the countries that hold them.

The decision to undertake these studies reflects the Committee's concern that the huge and growing imbalances in international trade flows constitute a serious threat to the health of the world economy. While the United States is posting unprecedented trade and current account deficits, others, notably Japan, the Federal Republic of Germany, Taiwan, and South Korea, are running up trade and current account surpluses of comparable significance. Over the long run, these imbalances cannot be sustained. The longer they continue, the greater the danger that markets will impose a correction in the form of a world recession.

Much of the discussion of world trade imbalances has focused on the adjustment tasks facing deficit countries. The Joint Economic Committee has contributed to the discussion, most recently with the August 1987 study "The Legacy of Foreign Debt," and in a number of earlier studies and reports. As the world's largest debtor nation, the United States has been the focus of much of this discussion, and it is clear that decisive changes are needed in a mix of U.S. policies to increase the ability of U.S. producers to compete in markets at home and abroad. This study is in no way intended to minimize the gravity of the U.S. trade deficit and the complexity of the challenge we face in attempting to reduce that deficit.

However, the task of remedying global imbalances does not rest exclusively with the world's deficit countries. A more balanced international trading system will also require policy modifications on the part of countries with large trade and current account surpluses. While from the perspective of an individual country surpluses may seem desirable, the benefits will continue to accrue only in the short term. When large surpluses -- and deficits -- persist

in the world trading system, they pose a serious threat to the functioning of the system as a whole. In the long term, the prosperity of all trading nations depends on the successful functioning of this system.

The JEC's studies of the world's major surplus economies are designed to explore the causes of surplus and the policy alternatives for addressing them. They start from a premise that recession in any country is a costly and undesirable solution to the problem of imbalance, for surplus and deficit nations alike. Their purpose is to provide a better understanding of the surplus phenomenon, thereby contributing to economic policies directed to assuring orderly reductions in world trading imbalances and minimizing the risk of world recession.

The sources of surplus are rooted in particular institutions and practices which vary from economy to economy, and therefore these studies are organized on a case-by-case basis. The first in the series focused on Taiwan, the trading nation with the highest ratio of current account surplus to GNP. The second study focused on the Federal Republic of Germany, the nation with the slowest growth rate among the major surplus nations. This third study focuses on Japan, the nation with the largest absolute surplus and lowest ratio of imports to production in manufacturing. A subsequent study will explore a fourth surplus country, South Korea.

The series is a collaborative effort among the international economists of the Committee staff who extensively review each study prior to release. This third study was written by Lee Price, Senior Economist on the staff of the Joint Economic Committee. The author is grateful for the assistance of the U.S. embassy staff in Tokyo for their assistance in the preparation of the study.

It is my hope that these studies will prove useful to you in analyzing the developments taking place in the world economy.

Sincerely,

Paul Sarbanes

Paul S. Sarbanes
Chairman

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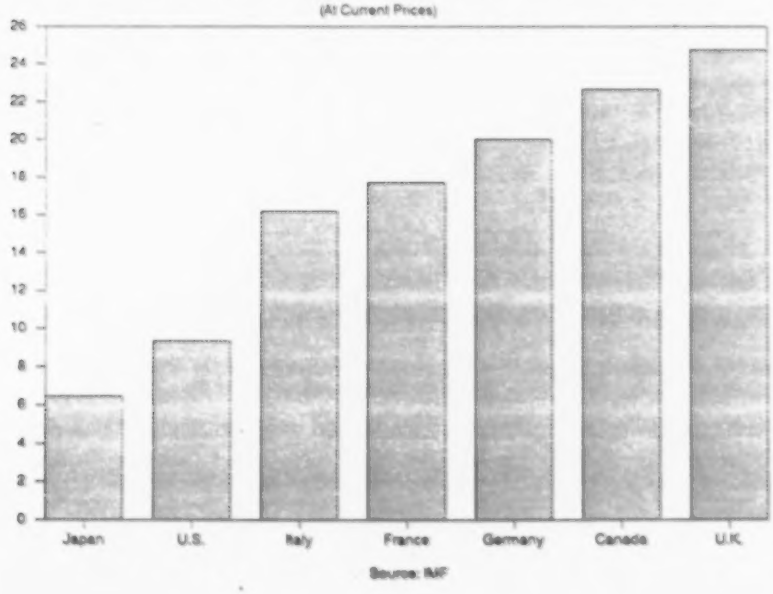
INTRODUCTION

With a population of 122 million and gross national product (GNP) of $2.6 trillion -- both roughly half the size of the United States -- Japan has the world's second largest economy. It is, however, a market in which foreign export competitors participate relatively little since Japan spends a lower share of its income on imports than any other major industrial market economy (see Figure 1).

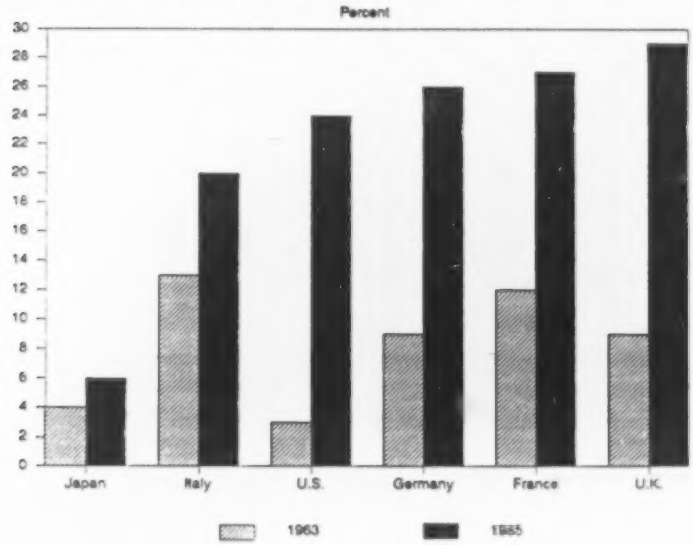
FIGURE 1
Imports as a Share of GDP, 1987



This low total spending on imports is all the more remarkable because the nation pays a relatively high percentage of income for imported raw materials and food.

It is the pattern of trade in manufactures that sets Japan apart. Imports supply a much smaller share of Japan's market for manufactured goods than in other industrial nations. Moreover, in contrast to other major industrial nations, this share has changed very little over the last two decades (see Figure 2).

FIGURE 2
Import Content of Finished Manufactures



Source: OECD, Structural Adjustment and Economic Performance, 1987

Japan's manufactured exports, which make up 98 percent of its total exports, now exceed those of the United States and almost match those of West Germany, a nation tightly enmeshed in two-way manufactures trade with the rest of Europe.

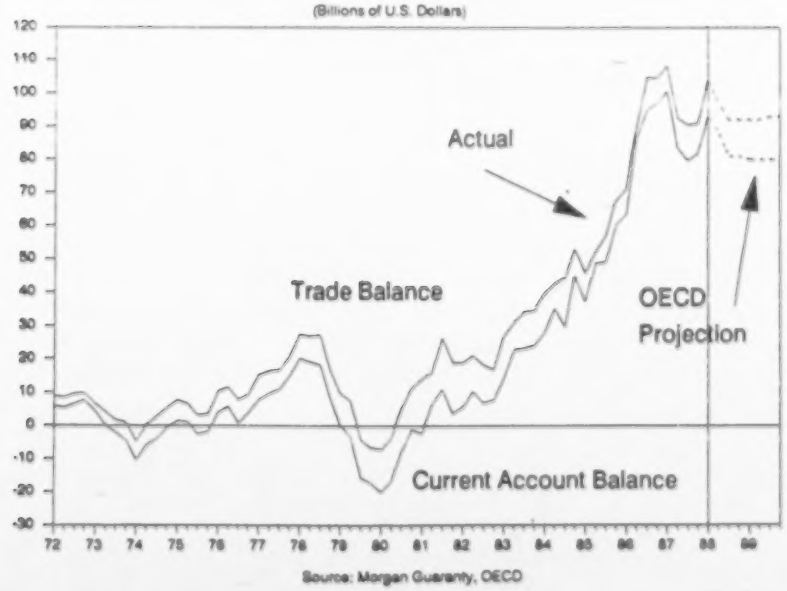
This study examines the buildup of Japan's extraordinary trade surplus since 1979 and the prospects for reducing it in the future. It outlines the dimensions of the surplus (and accompanying wealth abroad), examines the conditions underlying the trade surplus, and reviews recent Japanese efforts to adjust to the rapid appreciation of the yen since 1985. Finally, looking to the future, the study examines options for faster reduction of the surplus which could have important ramifications both for improving the standard of living at home and relations with the nations abroad.

RECORD TRADE SURPLUSES AND FOREIGN ASSETS

Last year, Japan recorded surpluses of $97 billion in merchandise trade and $87 billion in the current account. Both surpluses have risen every year since 1979 and have reached the highest levels ever recorded by any nation.

On the assumption of unchanged exchange rates, the Organization for Economic Cooperation and Development (OECD) foresees only a $2 billion decline in Japan's trade and current account surpluses in 1988 and a further $2 billion decline in the trade balance and a $5 billion in the current account balance for 1989 (see Figure 3). Looking even further into the future, those preparing Japan's new Five Year Plan have projected the current account surplus to remain as high as 2 percent of GNP in 1992. Coupled with other Plan projections, that implies a surplus of $70 billion at an exchange rate of 125 yen per dollar.

FIGURE 3
Current Account and Trade Balance

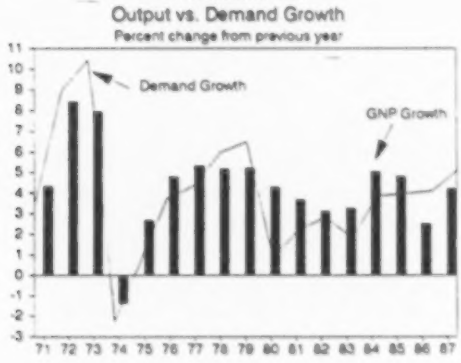


Source: Morgan Guaranty, OECD

Japan's trade surpluses and foreign wealth in the 1980's reflect a combination of traditional patterns and new elements. Japan has had "export-led growth" for decades, in the sense that the export sector has grown faster than the rest of the economy and propelled it forward. But until the early 1970's imports kept pace with exports and therefore large trade surpluses did not emerge.

Developments since 1979 have certain limited parallels to two periods in the 1970's, albeit on a far larger scale. In those periods, too, exports were growing much faster than imports. Indeed, the 15 years from 1971 to 1985 saw only four years in which domestic demand grew faster than domestic output (see Figure 4).

FIGURE 4



Years of relatively high domestic demand growth occurred in 1972-1973 and again in 1978-1979, in the wake of adjustments to large surpluses. In both cases, surpluses had developed, the yen then appreciated rapidly, and import volume increased. The trade surplus had already begun to taper off as a share of GNP when in 1973 and 1979 oil shocks actually pushed the Japanese trade balance into deficit.[1] In

[1] This does not mean that the possibility of future oil price hikes in and of itself provides justification for Japan's current large trade surplus. Japan is hardly unique among industrial nations in having substantial net imports of oil, and the international trading system could not be sustained if all oil importers tried to run trade surpluses large enough to cover potential increases in oil import costs. With a current account surplus now more than three times its oil import costs, oil prices could quadruple and Japan would still have a current account surplus.

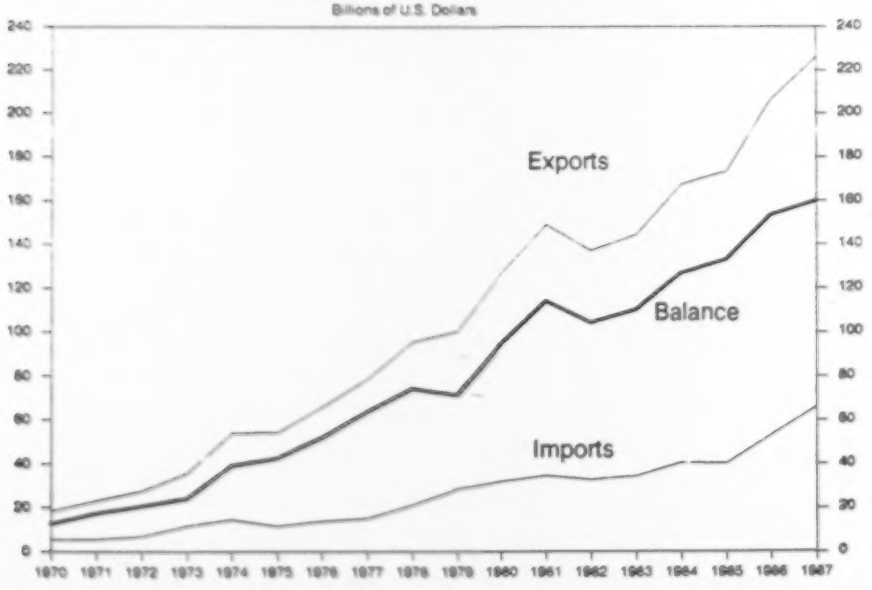
the 1980's, the relationship between the exchange rate and the trade balance was changed by the emergence of large capital flows.

CREATION OF THE TRADE SURPLUS SINCE 1979

Although Japan's trade balance rose every year from 1979 to 1987, underlying trends changed in 1985 when the period of rapid yen appreciation began. In 1979, Japan had an $8 billion trade deficit, equivalent to 1 percent of GNP. Exports rose 65 percent in volume terms over the next six years, while import volume rose only 4 percent.

The entire increase in Japan's trade balance in the six years between 1979 and 1985 can be traced to the manufacturing sector, particularly in competition with U.S. producers. Manufactured exports shot up 73 percent, to $173 billion, while manufactured imports increased by a third to $36 billion (see Figure 5). (For a discussion of the success of Japanese exporters relative to U.S. producers, see Appendix One.)

FIGURE 5
Manufacturing Imports and Exports



Rapid yen appreciation caused export volume to taper off and import volume to rise, but the trade surplus in financial terms whether measured in dollars or yen continued to climb from 1985 to 1987 (see Figures 6 and 7). During this period, exports rose more than imports in dollar terms and exports fell less than imports in yen terms.

FIGURE 6

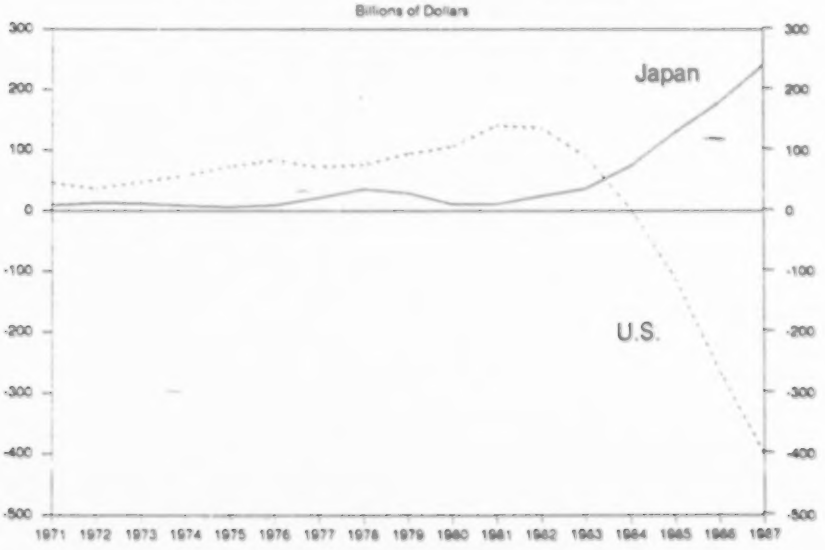
FIGURE 7

The seasonally adjusted dollar measures of both trade and current account surpluses have rebounded since mid-1987 (see Figure 3, on page 3). Despite a significant increase in the volume of imports, the nominal gap between exports and imports is widening for several reasons. As indicated in Figures 6 and 7, nominal exports are rising again after two years of decline. Export volume has begun to expand again and export prices are being raised in yen as well as in dollar terms. Exports have been running 75 percent greater than imports. If the rate of growth of imports is not 75 percent greater than the rate of growth of exports, the trade gap expands.

FOREIGN ASSETS AND EARNINGS

Japan has converted the earnings from its export surpluses into unprecedented purchases of financial assets abroad. At the end of 1980, Japan held $12 billion more in assets abroad than foreigners held in Japan. By the end of 1987, Japan had a net foreign asset position of $241 billion, far exceeding the record net asset position of $141 billion set by the United States in 1981 (see Figure 8).

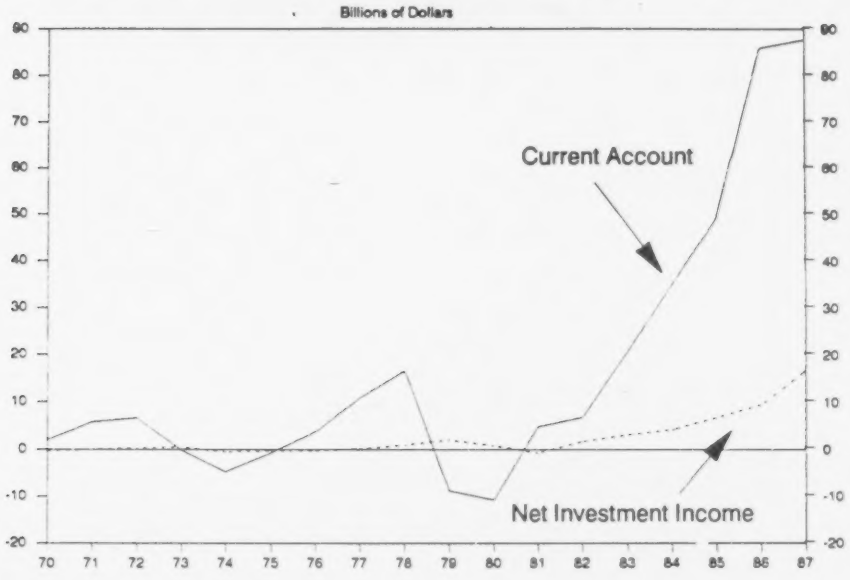
FIGURE 8
Net Asset Position of Japan and the U.S.



Source: Bank of Japan, U.S. Commerce Dept.

This extraordinary net asset position means rising net earnings on foreign investments that raise Japan's current account. As recently as 1981, Japan made higher payments on foreign investment in Japan than it had receipts on investments abroad. By 1987, net earnings on foreign investment reached $17 billion. They are now becoming an important component of the current account surplus as shown in Figure 9. Each year that the current account remains in surplus, Japan accumulates more net foreign wealth, which in turn should generate greater net investment earnings and more upward pressure on the yen.

FIGURE 9
Current Account, Net Investment Income



Paradoxically, while Japan's $87 billion current account surplus in 1987 made it the world's largest net lender, it was also the largest net borrower of short-term funds. According to the Bank for International Settlements (BIS):

> "net inflows of short-term capital soared [into Japan] from $59.4 billion in 1986 to a staggering $91.8 billion in 1987. The bulk of these inflows represented net short-term foreign borrowings by the banks--to a considerable extent in foreign currency--and appear to have been partly related to resident investors' desire to cover the exchange risk on their foreign investment."[1]

Japan's capital transactions in 1987 also included net lending of long-term capital of $136.5 billion, and net government lending of $42.3 billion. At the end of 1987,

[1] Bank for International Settlements, *58th Annual Report*, June 13, 1988, page 72.

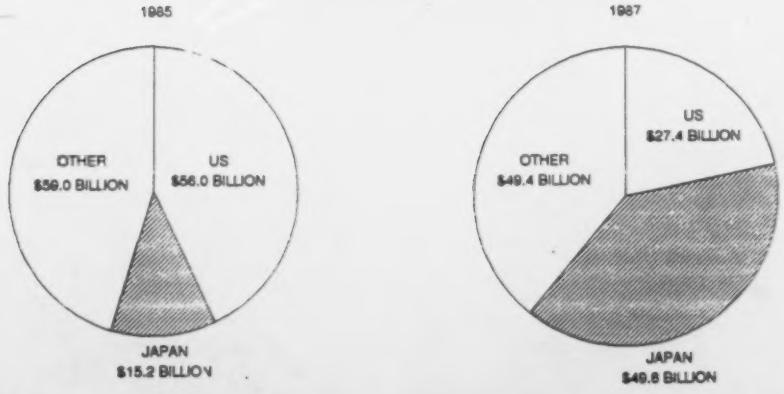
Japan had accumulated net foreign assets worth $241 billion, with net long-term assets of $410 billion offset by net short-term liabilities of $169 billion. It should be noted that, although Japanese financial institutions have invested heavily in long-term bonds with higher yields, the high turnover rate indicated by Japanese statistics for purchase and sales of foreign bonds indicates that they have been holding individual bonds for short periods of time.

Japan's net investment earnings reflect not simply its net assets but also its role as a financial intermediary with short-term liabilities and long-term assets. Part of net investment earnings derive from the fact that rates of return on long-term assets are generally higher than those on short-term assets.

Japanese investors have experienced foreign exchange losses since 1985 on their foreign assets, particularly those denominated in dollars. While U.S. bonds and notes have paid an average of three to five percentage points more than Japanese securities with comparable maturities, this differential has not offset the depreciation of the dollar relative to the yen.

On the other hand, Japan's financial institutions have pursued long-term goals that require acquisition of more foreign assets even at the risk of exchange rate losses. As the traditional tight constraints on investments abroad have been loosened, Japan's major insurance and pension funds have taken advantage of the opportunity to diversify their assets away from the yen. In addition, Japanese securities firms have recently begun moving aggressively into the New York and London bond and equity markets and are encouraging foreign as well as Japanese investors to use their services. For example, Japanese firms were the lead manager for 39 percent of the Eurobonds issued last year in contrast to only 12 percent in 1985 (see Figure 10).

FIGURE 10
Lead Manager of Eurobond Issues
By Nationality of Firm



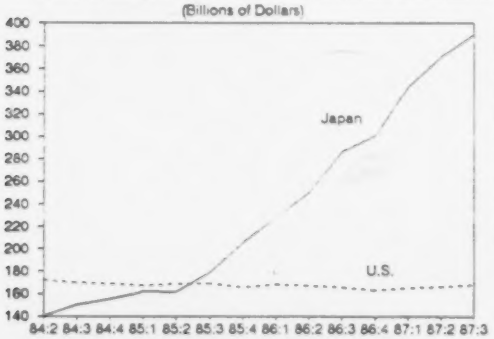
Japanese banks have also become much more active in international markets. Widely quoted international rankings of the asset size of banks are misleading in this regard because the U.S. banking system is more decentralized than the systems in Japan and other industrial nations. Comparisons of actual international activity by banks are more appropriate. For example, the relationship between Japan's net foreign assets and competition in international banking is shown by the trends in cross-border and foreign currency lending. Although they trailed American banks in such lending to nonbank borrowers as recently as the second quarter of 1985, Japanese banks now do more than twice as much of such lending as American banks (see Figure 11).

As part of this trend, Japanese banks have expanded their operations within foreign borders. Again the contrast with U.S. banks is striking. In the last five years, the assets of Japanese banks operating in the United States expanded from $113 billion to $294 billion, while the assets of U.S. banks in Japan stagnated at roughly $20 billion (see Figure 12).

FIGURE 11

International Claims on Nonbanks of U.S.- and Japanese-Owned Banks

(Billions of Dollars)



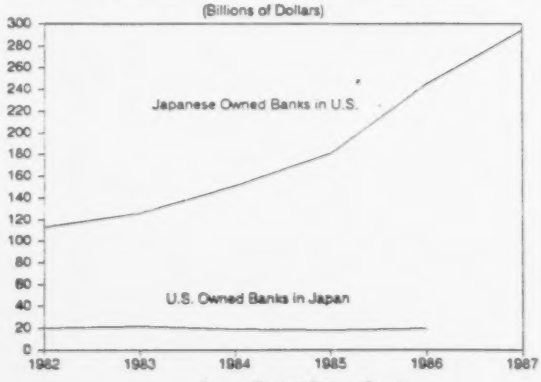
Source: Bank of International Settlement

Note: International claims include both cross-border claims and claims on domestic residents in a foreign currency.

FIGURE 12

Assets of Bank Branches and Sudsidiaries Abroad

(Billions of Dollars)



Source: Federal Reserve Board

Fears of disruption in its export industries and of exchange losses on Japanese holdings of non-yen financial assets have had a great influence on the Japanese government's position on international currency questions. Not long after the September 1985 Plaza Agreement to bring down the value of the dollar, the Japanese government began to express concern that the yen might appreciate too far or too fast. If yen appreciation must occur, the government prefers a slower pace in order to limit damage to export industries while resources shift to more domestically oriented industries. For that reason, when the yen climbed rapidly against the dollar several times in 1987, partly in response to curtailment by private Japanese investors of their purchases of dollar

assets, the Bank of Japan stepped in to purchase tens of billions of dollar assets. In 1987, the Japanese government acquired an additional $52 billion in net foreign assets while Japanese investors acquired only $7.5 billion in net assets privately (see Figure 13).

Private Japanese investors were not alone in their reluctance to acquire more dollar assets in 1987, but they were among the largest participants in the exchange markets and bond markets which became very sensitive to each other. Beginning in late March and again in August, a sharp decline in the dollar against the yen occurred, accompanied by a rise in U.S. bond rates and a drop in Japanese bond rates (see Figure 14).

This divergence between U.S. and Japanese bond rates suggests that investors -- Japanese and non-Japanese alike -- were moving out of dollar bonds and into yen bonds. Private investment in U.S. securities declined from $79 billion in 1986 to $36 billion in 1987. The persistently large external imbalances of Japan and the United States were important factors in the sharp setbacks in 1987 for three interrelated

FIGURE 13

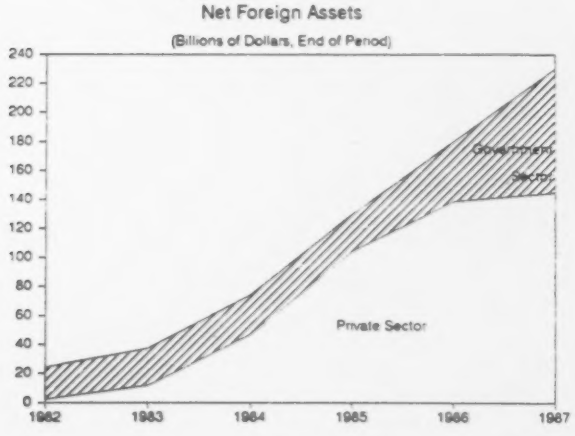
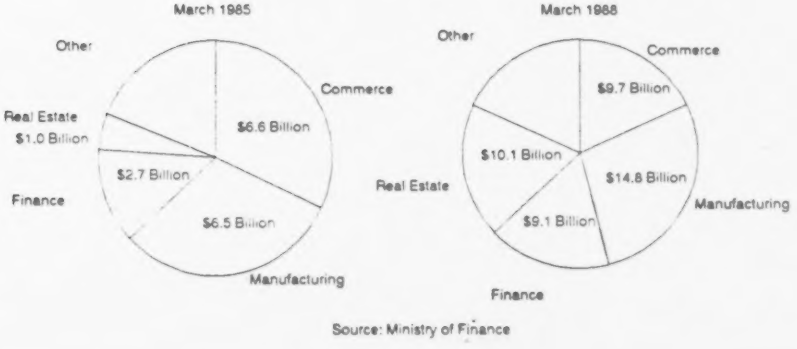


FIGURE 14

markets: dollars, bonds, and equities. In its analysis of the causes of the worldwide crash in equity prices, the BIS annual report describes the primary cause as "the uncertainty over how international payments imbalances would be resolved."[1]

In addition to financial holdings, Japan has also expanded its foreign direct investment (FDI).[2] By the end of March 1988, Japan had direct investments officially measured at $139 billion, of which $50 billion was invested in the United States. The character of Japanese direct investments in the United States has changed markedly in recent years. Traditionally, the largest investments here were in enterprises to distribute and service imports from Japan. While such commercial investments continue to grow, they have been overtaken by direct investments in manufacturing and real estate and almost overtaken by investments in financial institutions (see Figure 15).

FIGURE 15
Cumulative Japanese Foreign Direct Investment In the U.S. and Canada



Source: Ministry of Finance

[1] Bank for International Settlements, *58th Annual Report*, June 13, 1988, page 86.

[2] Japanese data on foreign direct investment are derived from declarations to the Ministry of Finance of plans to transfer funds from Japan for the purpose of making direct investments abroad. These data will overstate the level of FDI to the extent that such plans are not carried out. However, when Japanese firms borrow funds from abroad to make their direct investments, the data understate the value of directly controlled foreign assets.

The above data may substantially underestimate the value of assets controlled by Japanese investors in these industries because it is based on the value of funds transferred out of Japan. To the extent that Japanese investors borrow funds abroad as "leverage," they may acquire assets that exceed the value of the funds transferred out of Japan. For example, the Japanese FDI data show investment of $4.4 billion in real estate in fiscal 1987. However, Kenneth Leventhal & Company has estimated that Japanese investors actually bought real estate in the United States worth $12 billion in calendar 1987.[1]

Japan's investment in foreign manufacturing has stepped up since 1985, particularly in the United States and East Asia. Yet it remains at modest levels compared to domestic investment. For example, in fiscal 1986 Japan's manufacturers invested $3.8 billion in operations abroad, roughly 5 percent of their $84 billion of investment that year at home. That compares to their $1.7 billion of direct foreign investment in 1980, roughly 3 percent of domestic investment at the time.

Japanese multinational manufacturers produce far less abroad than their American counterparts. In 1985, the foreign affiliates of American-based manufacturing firms had output worth 24 percent as much as their U.S. parents. That same year, output by foreign affiliates of Japanese firms was only 3 percent of parent firm production in Japan.[2]

[1] Douglas Frantz, "Japanese Buy Record $12.7 Billion of U.S. Property," *Los Angeles Times*, April 5, 1988, Part IV, page 5.

[2] Susan MacKnight, "Offshore Production: Boon or Bane for the Japanese Economy?," Japan Economic Institute, Report No. 5A, February 5, 1988.

SOURCES OF EXPORT EXPANSION

The spurt in Japan's trade surplus in the 1980's resulted from macroeconomic policies at home and abroad that favored its exports while policies and practices in Japan continued to limit imports. The nation's manufacturers not only responded swiftly and effectively to exceptional export opportunities but they also benefited from shifts in investment patterns within Japan.

Government policies in the early 1980's facilitated massive investment shifts that worked to the advantage of exports. Lending for housing and public investment was curtailed; investment funds were freed to seek higher financial returns abroad; and, despite an overall decline in savings and movement of savings abroad, investment by manufacturers grew rapidly. With growth in output and employment propelled by the boom in exports, the government had room to impose a restrictive fiscal policy for eight consecutive years, from 1979 through 1986.

MACROECONOMIC POLICY CONTRASTS

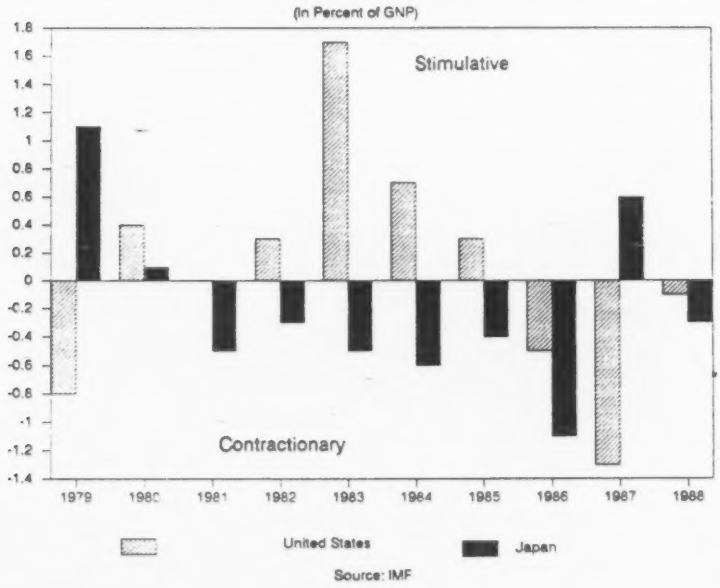
For much of this decade, the relationship between the policies pursued by Japan and the United States has shown more than the usual interdependence. Linked together by the expanding flow of capital from Japan to the United States, the fiscal policies of Tokyo and Washington approached symbiosis: Japan maintained a policy of reducing its fiscal deficits while Washington steadily increased its borrowing.

The boom in exports kept the contractionary effects of Japan's austere fiscal policy from materializing at home. That boom, in turn, depended heavily on American economic policies. American policies caused U.S. interest rates to rise, which attracted Japanese investors and kept the yen at levels very competitive for Japanese producers in competition with U.S. producers on world markets. American policies also stimulated rapid growth of domestic demand in the United States, Japan's most important export market.

Most economists expected the higher U.S. interest rates to depress interest-sensitive spending. This happened less than expected because foreign lenders, especially the Japanese, provided capital. Japanese and American fiscal policies would each have faced stronger political opposition in the absence of the other.

The contrast between the two nations' fiscal policies is striking. According to the fiscal analysis done by the International Monetary Fund (IMF), the fiscal policy of the Japanese central government had a contractionary effect for the period 1981 through 1986 while U.S. policy was neutral in 1981, expansionary from 1982 through 1985, and contractionary in 1986 (see Figure 16).

FIGURE 16
Effect of Central Government Policies

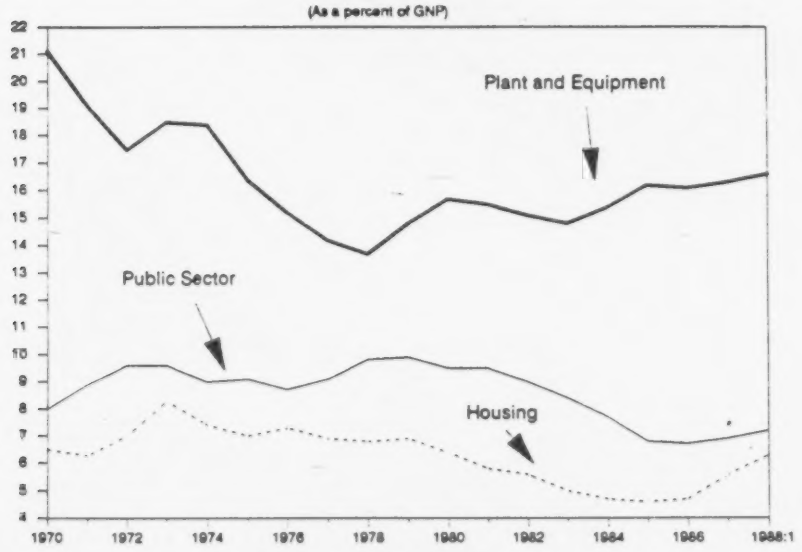


SHIFTS IN INVESTMENT

The other side of Japan's rising current account surplus from 1979 to 1985, the growing excess of domestic savings, was generated primarily by sharply reducing investment. Overall, fixed investment in Japan declined as a share of nominal GNP from 32 percent in 1979 to 28 percent in 1985. Despite the drop in overall investment, however, real investment in the manufacturing sector expanded rapidly. On the savings side, reduction in savings by households was largely offset by increased savings by government. In effect, the overall drop in domestic investment was largely replaced by net investment in assets overseas.

Housing construction fell substantially from the late 1970's to the mid-1980's. Between 1974 and 1979, spending on housing construction had hovered in a narrow range around 7 percent of GNP. That percentage dropped steadily through 1985 when it reached only 4.6 percent--one-third less than in 1979 (see Figure 17).

FIGURE 17
Types of Investment



Source: Economic Planning Agency

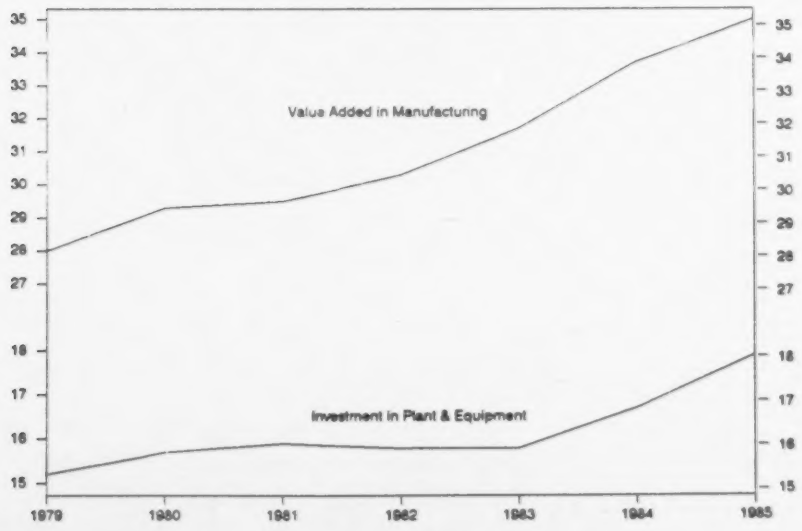
The drop in housing construction is explained largely by the reduction or elimination of several government programs to assist private investment in housing and the shift in private lending away from housing to meet the more lucrative demand for credit by other borrowers at home and abroad.

Conversely, the rapid appreciation of the yen since 1985 has been a boon to the housing industry. Private financial institutions have found domestic mortgage lending more attractive relative to foreign investment. In addition, with the threat of a slowing economy, the government expanded credit and other assistance for housing. In 1987 the number of housing starts surpassed the levels of the late 1970's, although the boom was concentrated in small rental housing and the amount of floor space under construction and share of GNP for housing still remain below 1979.

As in housing, investment in the public sector fell precipitously in the period 1979 to 1985, from 10 percent of GNP to 7 percent (see Figure 17). This cut in investment accounted for most of the 4 percent of GNP drop in the public sector deficit during that period. According to Ministry of Construction data, public investments in sewage systems, water supply, schools, hospitals, and land development were all sharply curtailed in 1983 and 1984 compared to previous years. Rapid yen appreciation and the consequent setbacks for export industries that began in 1985 have also brought a turnaround in public sector investment, although far more modest than in housing. The prospects for further expansion are examined in the discussion of fiscal policy later in this report.

Despite the decline in total investment, private investment in plant and equipment grew substantially from 1979 to 1985. Over the period, such investment grew almost twice as fast as overall GNP (50 percent as opposed to 27 percent) and its share of real GNP rose from 15 percent to 18 percent (see Figure 18). However, such investment absorbed only 1 percent more of GNP in nominal terms (see Figure 17) because investment goods did not rise in price as much as the GNP average. The sharp increase in real investment laid the basis for more exports, while the smaller increase in nominal investment meant that there was more savings available for investment abroad.

FIGURE 18
Shares of Real GNP

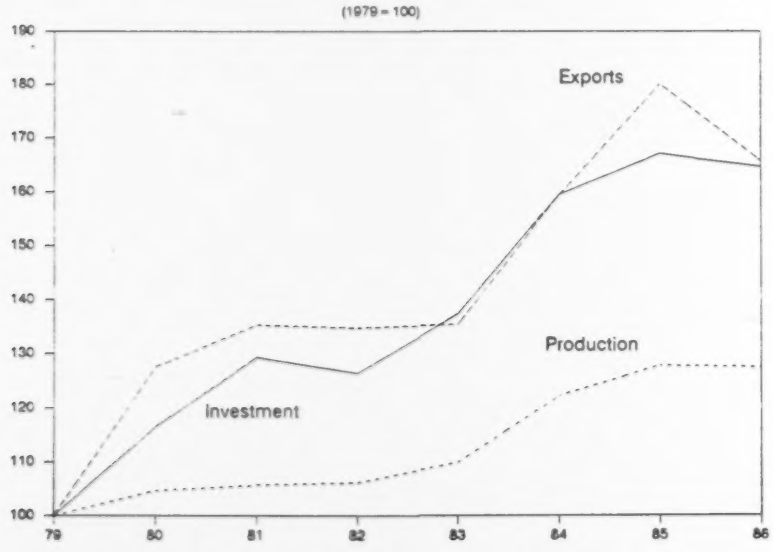


Source: Economic Planning Agency

Surveys of major businesses indicate that the manufacturing sector was increasing its investment faster than other sectors. Thus, the period 1979 to 1985 was not only marked by a shift of investment into private plant and equipment, but a rising share went into expanding capacity in manufacturing, particularly capacity related to exports. As a result, manufacturing output as a share of real GNP expanded from 28 percent in 1979 to 35 percent in 1985, an increase of 25 percent (see Figure 18).

Manufacturing firms increased investment on new equipment by 80 percent from 1979 to 1985 and their share of overall investment was rising, according to surveys. As indicated by Figure 19, the growth of manufacturing investment was accompanied by increased manufacturing output and more than matched by the export volume of manufactured goods.

FIGURE 19
Trends in Manufacturing, 1979-1986



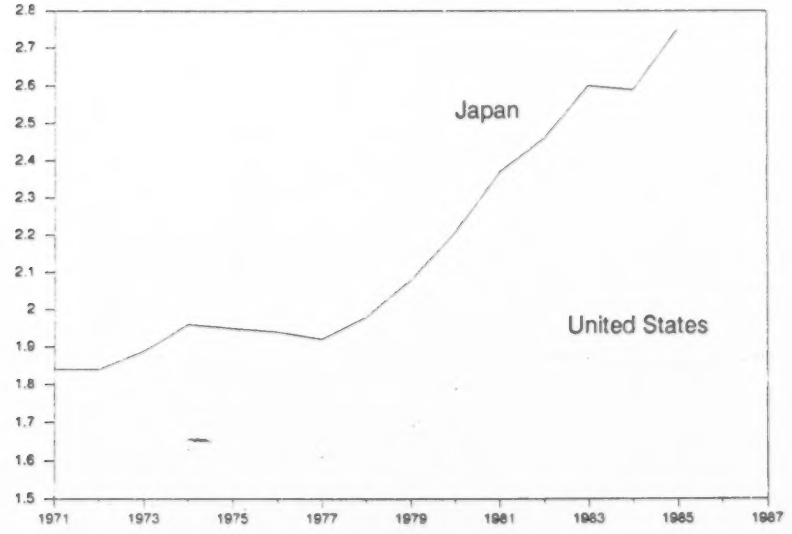
Sources: Bank of Japan, Japan Tariff Assoc., Ministry of Finance

From the standpoint of policy and politics, business spending to hire and train labor represents an important form of investment not reflected in the national income accounts for investment. The major manufacturing firms have a policy of "life time employment." Under this policy, most of the work force is protected against job loss until retirement age at 55 or 60. The share of employment in manufacturing sector did not decline in the 1980's as it had in the 1970's. Since the sector continued to post much

faster productivity growth than the rest of the economy, its share of total output grew rapidly. The combination of the enlargement of the manufacturing work force due to expanded production for export and the "life time employment" policy will affect the size of the manufacturing sector for some time to come.

Consistent with the general pattern of a shift of investment into more commercially oriented activity, research and development (R&D) expenditures rose sharply from 1979 to 1985. The share of the nation's economic activity allocated to R&D went up by a third, from 2.1 percent of GNP in 1979 to 2.8 percent in 1985 (see Figure 20).

FIGURE 20
Nondefense R&D as a Percent of GNP



Source: National Science Foundation

Although Japan devotes the same 2.7 percent of GNP to R&D as the United States, almost all Japanese R&D is for nondefense purposes. In 1985, the last year of comparable data, Japan spent 50 percent more of its GNP on nondefense R&D than the United States (2.7 percent versus 1.8 percent). In total dollar amounts, Japan spends 90 percent as much on nondefense R&D as the United States.

GATES OPENED FOR CAPITAL OUTFLOW

While Japanese government policies led to a reduction in total investment spending at home, they expanded opportunities for investments abroad. In the late 1970's, the Ministry of Finance (MoF) ended its traditional tight control on overseas investments and began permitting substantial capital outflows. In the context of the growing imbalance between internal savings and investment in both Japan and the United States in the 1980's, the change in capital policy had significant effects on exchange rates, interest rates, and trade.

Prior to 1978, Japan's major financial investors, particularly the insurance companies and pension trusts, had been virtually precluded from holding foreign securities. The Foreign Exchange and Foreign Trade Control Law was amended in 1979 (effective December 1980) to reflect the changing administrative practice of permitting financial institutions to acquire foreign securities at a controlled pace. Over time, the MoF has progressively permitted them to invest more of their portfolios abroad.

The policy on capital outflow overwhelmed a broader policy designed to internationalize the yen, a policy that the U.S. Government actively supported. That broader policy included measures to permit greater foreign borrowing in yen terms in Tokyo, greater access for foreign financial institutions to operate in Japan, and creation of new financial instruments.

In practical terms, however, the result of Japan's change in capital policy has been a flood of capital out of Japan but only a trickle into Japan. Between 1982 and 1987, $465 billion in long-term capital flowed out of Japan, while only $49 billion flowed in. A substantial portion of the capital outflow went into U.S. bonds and permitted the U.S. budget deficit to be financed with less pressure on U.S. interest rates.

Allowing Japanese financial investors to take advantage of higher interest rates abroad worked to the benefit of Japan's export industries. The large net capital outflows offset upward pressure on the yen from Japan's mounting trade surplus. The yen did not strengthen as promptly in the 1980's as it had in the mid-1970's. The yen began to appreciate sharply in late 1976 when Japan's current account had reached barely 1 percent of GNP. The new rules permitting capital outflows in the 1980's help to explain the absence of strong yen appreciation even as the current account expanded steadily to reach 4 percent of GNP (see Figure 21).

FIGURE 21

Exchange Rate and Current Account

To the extent that the outflows went primarily into dollar assets, they also contributed to upward pressure on the dollar, giving Japanese producers an additional cost advantage over U.S. producers in international markets. With the Japanese government committed to fiscal austerity (until mid-1987), it very much welcomed the boost that capital outflows gave to exports.

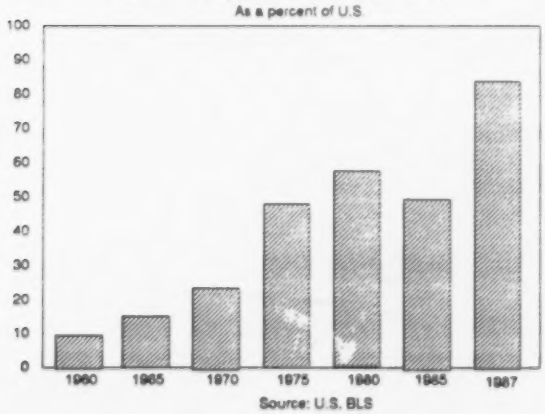
LABOR COSTS AND PRODUCTIVITY

Lower labor costs have also contributed to the trade success of Japanese manufacturing in the 1980's. Although the gap between the hourly labor costs in Japan and in the United States has been narrowing, a gap still remains. In 1960, when technology and productivity in Japan lagged far behind North America and Europe, hourly labor costs in Japan were only 10 percent of U.S. costs -- comparable to the newly industrializing economies of East Asia and Latin America today. As the gaps in technology and productivity have closed, hourly labor costs in Japan have risen faster than in the United States. The yen has appreciated and, as a result, Japanese hourly labor costs in manufacturing were 84 percent of U.S. labor costs in 1987 at the average exchange rate for the year of 144 yen per dollar (see Figure 22). The gap would be narrower at current exchange rates.

Hourlylabor costs tell only part of the story. To evaluate the trends in a nation's competitiveness, hourly labor costs can be adjusted for productivity changes to calculate so-called unit labor costs. In comparison with the United States and most other competitors, Japan's manufacturing sector has had faster productivity increases so that its unit labor costs have risen much less than hourly labor costs. As shown in Figure 23, Japanese unit labor costs fell more sharply relative to U.S. unit labor costs in the early 1980's than did hourly labor costs.

FIGURE 22

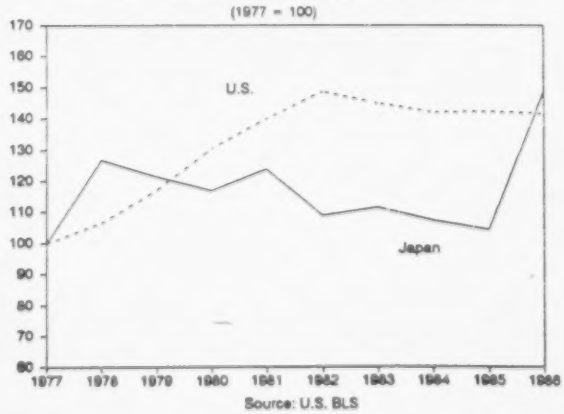
Japan's Hourly Manufacturing Labor Costs



Source: U.S. BLS

FIGURE 23

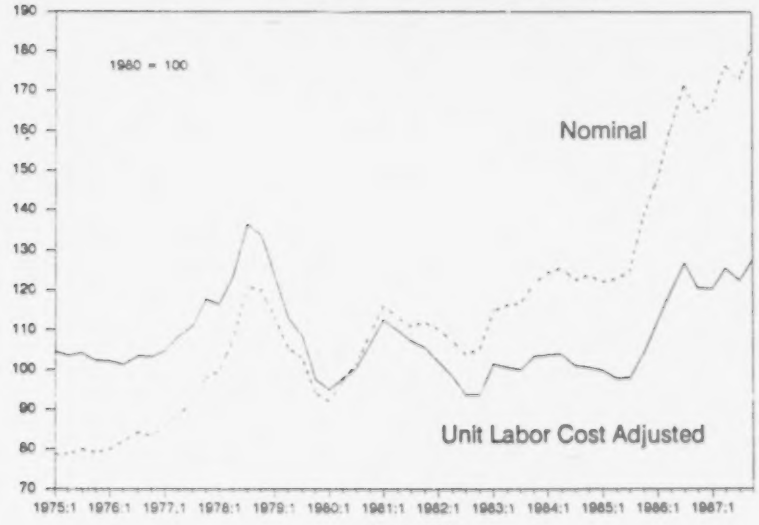
Unit Labor Costs in Manufacturing, U.S. Dollar Basis



Source: U.S. BLS

Japan's unit labor costs have remained remarkably low relative to the world as a whole despite the dramatic nominal appreciation of the yen. Figure 24 shows that, if the nominal yen appreciation is adjusted downward for the lower increases in unit labor costs for Japan than for its trade competitors, Japanese manufacturing was more competitive at the end of 1987 than it had been in late 1978. During the rapid expansion of exports up to 1985, Japan's unit labor cost adjusted exchange rate was particularly low.

FIGURE 24
Trade - Weighted Exchange Rate Indices
Nominal and Unit Labor Cost Adjusted



Source: IMF

BACKGROUND TO SLUGGISH IMPORTS

Among industrial nations, Japan has a unique trade pattern. On the export side, although they may seem ubiquitous, Japan's export products are concentrated in a few industries. On the import side, there is very low import penetration in the industries for which Japan has significant domestic production. In terms of obvious impediments to imports, the Japanese economy appears relatively open. Its tariff rates rank among the lowest in the world and few quotas remain. According to Japan's critics, however, this trade pattern -- focused exports and very limited imports -- is the result of an aggressive strategic industrial policy and widespread trade protection.

The more significant import barriers are less visible and are not quantifiable: government "guidance" of industry, regulations which work in favor of domestic producers, periodic support for industries when they become less competitive, creation of "depression cartels," and toleration of cartel-like business relationships developed in manufacturing, agriculture, construction, and distribution. Although most of these practices grew up to serve a variety of purposes, they have the effect of curbing imports. Recent books with many scholarly case studies document Japanese government support for specific successful export industries and less visible trade barriers. 1

INDUSTRIAL POLICY AND CARTELS

The Japanese government has placed a high priority on developing a successful manufacturing sector. Unwilling to leave to market forces the exclusive responsibility for determining the structure of its industry, important ministries have cooperated with

[1] See, for example. Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975*, Stanford University Press, 1982; Miyohei Shinohara, *Industrial Growth, Trade, and Dynamic Patterns in the Japanese Economy*, Tokyo University Press, 1982; Clyde Prestowitz, *Trading Places: How the U.S. Allowed Japan to Take the Lead*, Basic Books, 1988; and Bela Balassa and Marcus Noland, *Japan in the World Economy*, Institute for International Economics,

industry to accelerate the expansion of manufacturing, particularly for export. As Miyohei Shinohara explains:

> "For Japan with only a partially developed economy, a late starter on the road to industrialization, the general consensus was to obtain economically advanced status as quickly as possible. To reach this goal, it was necessary for the government to take the lead in guidance and direction. It was often necessary that government be the mediator to placate the vital and active firms in the private sector. It was no mistake that government provided supportive industrial measures for those businesses with comparatively higher income elasticity and with relatively higher speed in technical progress." (p. 40)

Shinohara identifies the tools used for these industrial policies as special tax measures, low-interest loans by quasi-governmental financial institutions, import restrictions, coordination of investment in plant and equipment, promotion of economies of scale through mergers, deferment of trade and capital liberalization, and other forms of "administrative guidance." (p. 39)

The two most important ministries intervening to assist the development of Japanese manufacturing have been the MoF and Ministry of International Trade and Industry (MITI). MoF plays a central role in fiscal, tax, money, and credit policy. It oversees the budget where it directly develops tax policy and sets the ground rules for fiscal policy. MoF has close links with private financial institutions whose top ranks are filled with former MoF officials. Over the years, MoF has worked to encourage private savings and favor credit being channeled into industry rather than to consumers. Japan's central bank (Bank of Japan) generally defers to MoF. MITI regularly publishes "visions" of the desirable developments for specific industries or groups of industries. These visions derive from close consultation with companies in the industries and with outside experts. Although companies are not bound by law to conform to the "visions" and the consequent administrative guidance from MITI, they defer to a degree that American businessmen find surprising, for reasons described by Michio Morishima:

> "Since the Meiji period,[1] the business world has always been guided by the government, and has reaped the benefits by swarm-

[1] The Meiji period, which began in 1868, brought a major shift in the policy of the Japanese government away from almost complete isolation from the rest of the world and toward significant economic ties with the West.

> ing around the government. ...even though a government communication might be no more than a suggestion, a request or a notification and with no binding force, in as far as it came from MITI at all any enterprise feared a cold reception should they fail to comply and therefore had no choice but to do so. In Japan to be deserted by the government is to be relegated to being a second-rate enterprise. As a result all major enterprises have not only moved their head offices to Tokyo, but also taken on as directors former high officials of MITI and the Finance Ministry in an attempt to preserve close contacts with the government."[1]

Two recent panels assembled under the auspices of the General Agreement on Tariffs and Trade (GATT) with members acceptable to Japan concluded that "administrative guidance" was "a traditional tool of Japanese government policy based on consensus and peer pressure" and that "in the special circumstances prevailing in Japan could therefore be regarded as a governmental measure enforcing supply restrictions."[2]

The companies are motivated to follow MITI guidance not only by tradition and peer pressure, but also by practical rewards, as Shinohara explains:

> "...it has been much more effective to have the negotiations mediated [by MITI], leading to a great deal less redundant equipment than if investment were made by a disunified approach. Moreover, companies can then attempt the enormous amount of investment needed without worrying so much about future risks, since they are assured that MITI will step in if difficulties arise." (p. 39)

When difficulties arise, MITI steps in to help arrange cartels and discourage purchase of imports. In Japan, the two oil shocks reduced the competitiveness of goods produced by energy-intensive industries but nonetheless imports of such goods have remained at remarkably low levels. Twenty-two "depressed industries" have been protected under the 1983 extension of the 1978 Temporary Measures Law for the

[1] Michio Morishima, *Why Has Japan Succeeded?: Western Technology and the Japanese Ethos*, Cambridge University Press, 1982, pages 189-90.

[2] General Agreement on Tariffs and Trade, "Japan - Trade in Semiconductors: Report of the Panel," 03.02.88, page 38, quoting in part "Japan - Restrictions on Imports of Certain Agricultural Products: Report of the Panel," November 18, 1987.

Stabilization of Specific Industries. Among the industries protected by the law have been aluminum, ammonium, cement, cotton spinning, ferroalloys, nylon staple, paper, petrochemicals, phosphoric acid, polyester filament, polyester staple, shipbuilding, soda ash, steel, sugar, urea, and wool yarn. Many of these industries make intensive use of energy, which is expensive in Japan.

All the "depressed industries" have become uncompetitive in international markets and therefore vulnerable to rapid increases in imports in the absence of barriers. These laws were supposed to assist the steady reduction of Japanese capacity and increase in imports. With rare exceptions, MITI has successfully helped these industries to coordinate cutbacks in capacity, but Japanese production in these industries has not been scaled back.[1] A few industries are specifically protected by high tariffs. In the case of both urea and soda ash, the books by Balassa and Noland and by Prestowitz have documented evidence of quiet agreements between the industry and its purchasers to restrict their purchases of imports. There is at present no comparable documentation to explain the low imports of the other depressed industries.

According to the annual report of the Japanese Fair Trade Commission (FTC), cartels are legally sanctioned in dozens of industries, including chemical fertilizers and liner board. Cartel-like behavior has been observed in other industries not on the FTC list.

Cartels present a serious trade problem when they coincide with closed domestic markets. In an open economy, cartelization should present an opportunity for foreign exporters. When cartels raise prices, as they have done in Japan, imports rush into open markets at lower prices. In Japan, not only have imports remained low in cartelized industries, but some of the cartelized industries have continued to be major exporters.

AGRICULTURE AND LAND POLICIES

The interconnected policies on agriculture and land profoundly affect much of the Japanese economy. For a nation with a population of 122 million, Japan devotes

[1] With both production declines and substantial import growth, the aluminum industry represents a notable exception. The aluminum industry had become particularly uncompetitive due to the high energy component in its costs. Moreover, aluminum comprises a significant part of the costs of some export industries that could not afford to pay much above world market prices.

very little land to urban use. Three-quarters of its land is taken up by mountains and forest and two-thirds of the remaining land is farmed.

With vivid memories of food scarcity during World War II, the Japanese often express concern for maintaining agricultural self-sufficiency and the government provides strong incentives to keep land in farming. Both chambers of the Diet unanimously passed resolutions in support of the ban on rice imports as recently as 1980 and 1984.

Strict quotas and large subsidies help to maintain the profitability of many farm products at costs often two to 10 times greater than world market prices. Taxes on farmed land can run as low as 1 or 2 percent of those on residential land. As a result, vast amounts of land are cultivated in scattered small plots throughout major urban areas, particularly with rice or trees.

Despite these incentives for farming, however, substantial erosion of self-sufficiency has occurred. As recently as 1960, Japan produced 82 percent of the grain (including rice, other edible grains, and feed grains) and 79 percent of the calories it consumed. By 1983, those self-sufficiency ratios had fallen to 32 percent and 54 percent, respectively.[1]

The sale of land is discouraged because annual property taxes are low relative to the sales and inheritance taxes on land. This applies to all land, regardless of its current use, and restricts the supply of land available for development.

Land development is slowed because developers must negotiate payments to neighbors to give up their right to sunlight and payments to tenants -- including small businesses -- to give up their right to remain in their location. More intensive use of land is impeded by the inadequacy of central sewage systems and congested traffic. Because the average height of buildings remains just over two stories in Tokyo -- and even lower in other urban areas -- the cost in terms of land required for each square foot of floor space is extremely high. As land and floor space costs have soared, some developers have found it profitable to invest time and money in negotiating with neighbors, tenants, and government to arrange high-rise construction. The skyline emerging around a few major business and shopping areas attests to their success.

[1] Organization for Economic Cooperation and Development, *National Policies and Agricultural Trade: Country Study Japan*, 1987, page 145.

Proponents of fundamental reform of land, agricultural, and public works policies envision a transformation of the Japanese landscape and economy. For them, freer trade in agriculture and a major public works effort would lead to more affordable and better housing, greater demand for leisure time, and more interest in consumption. Some steps along these lines have been taken in recent years but they have faced strong resistance. Current agricultural policies are backed not only by farmers but also by a politically potent network of farm cooperatives that supplies farmers with seed, feed, fertilizer, credit, and insurance, and in addition purchases, processes, and distributes their production. Moreover, owners of urban land would object to radical changes that might threaten their property values.

AFFILIATED BUSINESSES

Perhaps more significant than government-initiated barriers to imports are the barriers created by the private sector. These barriers tend to favor established domestic producers at the expense of imports or even newcomer Japanese producers.

The pattern of formal and informal relationships among Japanese corporations puts imports at a disadvantage. Daniel Okimoto has described the significance of these relationships for foreign producers seeking to supply the Japanese market, particularly with machinery and components used by other businesses:

> ...structures of corporate interdependence, subcontracting networks, and long-term, reciprocal relationships raise significant barriers to foreign producers trying to break into the Japanese market....having to break into a labyrinth of intertwined networks is much harder than selling into a less structured market like America's, which functions more on the basis of spot transactions. In Japan, the framework of interdependence is reinforced by a business culture that prizes mutual trust and reciprocity....
>
> In Japan, corporate consumers of intermediate goods place prime importance on establishing close working relationships with supplier firms. They want to work out together new product designs, technical specifications, and the manufacturing details. They also

> want to be able to ask suppliers to cut prices when business conditions call for it. Such cooperation requires both sides to enter into long-term, reciprocal relationships. For foreign firms wishing to break into a network, it is essential to have manufacturing facilities located near corporate customers so that the continual give-and-take of long-term negotiations can be carried out.[1]

Prior to World War II, the Japanese economy was dominated by a few large and powerful family-owned conglomerates engaged in multifaceted manufacturing, finance, and foreign trading (zaibatsu). During the postwar occupation of Japan, the U.S. attempt to break up the zaibatsu was only partially successful. A more loosely knit system of keiretsu often bearing the same name (e.g., Mitsubishi, Mitsui, Sumitomo) arose in their place. Each keiretsu typically includes a major bank, a sogo sosha (trading company handling most of the imports and exports of the keiretsu's affiliates), and noncompeting industrial firms in steel, electronics, appliances, components, machinery, and similar industries. These firms own significant portions of each other's stock.[2] As much as possible, each keiretsu member is expected to conduct its business with keiretsu affiliates and to avoid doing business with their competitors.[3] According to Japanese experts on keiretsu practices, the competitive pressures of a much stronger yen are forcing some Japanese firms to choose import suppliers over keiretsu affiliates.

In fact, intra-industry ties between original equipment manufacturers (OEM's) and their component suppliers are often tighter than interindustry keiretsu ties. The

[1] Daniel Okimoto, "Outsider Trading: Coping with Japanese Industrial Organization," in Kenneth B. Pyle, *The Trade Crisis: How Will Japan Respond?*, Society for Japanese Studies, Seattle, 1987, pages 96 and 90-91.

[2] A substantial portion of the stock of the average company on the Tokyo Stock Exchange (TSE) is never traded because it is held by its keiretsu affiliates. This percentage increased from the late 1960's to the mid-1970's as keiretsu members raised their holdings to prevent foreign takeovers when government restrictions on foreign ownership were lifted. Some experts have suggested that this mutual support in the equity market helps explain the fact that, despite much loftier price-earnings ratios, stocks on the TSE declined less than those on exchanges in the rest of the world in October 1987.

[3] Some stock analysts in Japan have accounted for the extraordinary demand for stock in the recently privatized telecommunications monopoly Nippon Telegraph and Telephone (NTT) (price-earnings ratio of 270) on the basis that other major companies are buying it in the hope of obtaining keiretsu-type favored treatment.

major OEM's in the auto, machinery, and equipment industries have a large number of suppliers whose production is dedicated solely to a single OEM. Over the years, they have developed products together and shared fat years and lean years. In recent lean years, the OEM's have expected their suppliers to accept price cuts of 10 to 20 percent, along with production cuts of the same magnitude.

Whether the arrangements are formal or informal, the barriers confronting potential importers of equipment or components cannot be overcome quickly or easily. The common prescriptions for raising Japan's imports -- a higher yen and more rigorous sales efforts by foreign exporters -- have had a limited effect in overcoming these barriers. The higher yen has induced some well-established Japanese suppliers to shift production offshore. But to participate in Japan's market for producer goods on a significant scale, newcomer suppliers usually find that they must either license their technology or enter into joint ventures with well-connected Japanese producers. In either case, most of the newly supplied production ends up being manufactured in Japan and not imported. According to a study by a Japanese expert on science and technology, Akio Etori, Japanese entities made 32,000 contracts to obtain foreign technology over the period 1950 to 1978. Mr. Etori computed the total cost of those contracts at $9 billion and concludes that "for a fraction of the U.S. annual expenditure on science and technology, Japan closed the technology gap."[1]

DISTRIBUTION SYSTEM

The structure of the distribution system, at both the retail and wholesale level, also has the effect of impeding imports. The inefficiency of the system further increases prices to consumers. Japan's Economic Planning Agency has estimated that the Japanese distribution system's productivity is 31 percent below that of the United States.

The small stores that dominate the retail level present a difficult and expensive distribution network for importers to penetrate. Since smaller stores generally carry smaller inventories and less variety, they are much less likely to carry imports than larger stores.

[1] Victor F. Zonana, "When It Comes to Forging Alliances, Japan Proves a More Willing Partner," *Los Angeles Times*, February 22, 1988, Part IV, page 5.

The dominance of small stores is reinforced by law. A movement toward larger stores was halted by the Large Retail Store Law of 1974. In the 20 years before that law, stores with more than 50 employees had expanded their share of retail sales from 9 percent to 21 percent. Eight years after the law, their share had dropped back to 20 percent.[1] Under the law, both councils and MITI must approve the opening of a large store. Since small shopkeepers sit on the local councils and constitute the major urban base of support for the ruling party, the Liberal Democratic Party (LDP), such approval is rare.

The situation at the wholesale level complicates the problem further. Foreign exporters of consumer goods considering whether to supply small retailers not only face heavy marketing expenses–but also the resistance of powerful wholesalers. Small retailers depend on their suppliers for credit, other financial assistance, and expertise. Wholesalers usually permit small retailers to sell on consignment, which spares them inventory expense. Wholesalers often provide business advice for salesmanship, displays, accounting, etc. This is particularly helpful to the many small retailers who have gone into business after retirement from their first career at age 55. In addition, wholesalers and manufacturers use their leverage to prevent their purchasers from changing to cheaper sources of supply. Japanese wholesalers and the few major retailers have traditionally shown little interest in the past in obtaining imports. Recently, however, second tier depar.ment stores have begun carrying low-cost imports from Korea, Taiwan, and other Asian nations in addition to the traditional luxury imports from Europe and the United States.

There is a sharp contrast between Japan and the United States in this respect. Japanese officials often complain that American companies do not "try hard enough" to sell in the Japanese market, as if Japanese companies took all the initiative in penetrating the U.S. market. In fact, however, American wholesalers and retailers have considerable independence in choosing their suppliers, and they often have been quick to seek out lower cost foreign suppliers. Over the last two decades, they have initiated and expanded relationships with foreign manufacturers.

The ability of U.S. retailers and wholesalers to switch to import suppliers with impunity does not inevitably result from traditional American business practices. Indeed, in the early stages of penetration by Japanese competitors, American manufacturers of cars, televisions, and other products tried to prevent their distributors from also carrying Japanese products. They were unsuccessful because U.S. distributors' in-

[1] Edward J. Lincoln, *Japan: Facing Economic Maturity*, Brookings Institution, 1988, page 276.

dependence has been enforced by American antitrust authorities in the Federal Trade Commission and Department of Justice. The counterpart agency in Japan, the Fair Trade Commission, has never had the political mandate to enforce such independence. Indeed, Japan's FTC has a very different mandate. It presides over retail price maintenance arrangements and works with manufacturers to establish "fair competition codes" whose practical effect is to reduce the competitive threat posed by newcomers to the market.

CONSTRUCTION INDUSTRY PRACTICES

The construction industry provides another example of private economic structures impeding potential foreign suppliers with government assistance. The so-called dango system has traditionally determined the allocation of work on Japanese construction projects without competitive bidding.[1] Under the system, potential competitors meet on a regular basis to discuss upcoming projects and to reach a consensus over which company will do what portions of the work. With the exception of joint ventures based in Japan, foreign firms do not participate in the dango system and foreign-made equipment is rarely used.

In recent years, foreign companies have taken an interest in participating in major Japanese construction projects like the Kansai airport (being built offshore from Osaka) and the Tokyo Bay Bridge. As a matter of international economic balance, the potential stakes go beyond imports of the services of construction companies for design and management of these two projects. Foreign construction companies are much more likely to import foreign materials and equipment for use on projects than Japanese companies. Since the Japanese government has plans for public construction projects worth tens of billions of dollars in coming years, foreign construction companies and foreign governments have strong incentives to push for a more open system.

[1] For a detailed description of the dango system in construction, see Nobuo Takahashi, "'Dango' Underpins Construction Bid System," *Japan Economic Journal*, October 10, 1987; Bruce Roscoe, "The Tightest of Closed Shops Still Prospers," *Far Eastern Economic Review*, June 11, 1987, page 71; Karl Schoenberger, "Construction in Japan Runs on Dango: Collusive Inner Circle Hurdle for U.S. Firms Despite Recent Pact," *Los Angeles Times*, April 3, 1988, Part IV, page 6.

EFFECTS OF IMPORT BARRIERS

Since many of Japan's import barriers take subtle forms, the measurement of their impact is difficult. Nonetheless, the available evidence on the magnitude of these barriers suggests that they are quite substantial: prices of goods in Japan far exceed those in other industrial nations; import penetration remains low in the dozens of industries where cartels have been formed to bolster domestic prices; over the last three years of rapid yen appreciation, export prices have been cut far more than domestic prices; and imports grew very slowly during the earlier 1979-1985 period despite exceptionally strong economic growth and the rising value of the yen.

Japanese consumers must pay much more than consumers in other industrial nations for equivalent traded goods -- indeed, the retail prices of goods made in Japan often run much higher there than in the United States. When Japanese travelers go abroad and discover made-in-Japan manufactured goods at substantially lower prices, they often return with large quantities.[1] Recent estimates by the OECD and Nomura Research Institute suggest that prices in Japan average 80 percent higher than U.S. prices for comparable products. Some of that difference no doubt results from the inefficient Japanese distribution system. However, Nomura has also estimated that Japanese prices are almost 50 percent higher at the wholesale level, a discrepancy that cannot be attributed to the distribution system.

One of the factors contributing to higher prices in Japan are the cartels which operate in both export and import competing industries. Whether the industry exports or not, domestic prices tend to exceed world market and Japanese export prices in cartelized industries. Such differences in prices could not be sustained if imports had open access to the Japanese market.

Whether an industry operates as an officially recognized cartel or not, when import barriers permit it to charge domestic prices above world market prices, it can make use of the additional profits to become more aggressive in exporting.

The response of Japanese exporters to the rapid yen appreciation since 1985 provides further indication of the closed nature of the Japanese market. Japanese export prices have fallen sharply relative to domestic wholesale prices (see Appendix Two for more detail). This implies a kind of price discrimination by Japanese producers, with export prices bearing little relationship to domestic prices. In some cases, export

[1] Damon Darlin, "Japanese Learn Thrills of Bargain Shopping from Mentors Abroad," *Wall Street Journal*, March 11, 1988.

prices may have been higher than domestic prices in 1985 but dropped below them by 1987. Since price discrimination can persist only if the two markets are kept separate, Japanese exporters appear able to keep their exports from reentering the domestic market to undercut domestic prices.

A possibly extreme example of price discrimination occurred recently with cordless telephones. Retailers directly supplied by the Japanese manufacturer sold the phones for the equivalent of $657. Another firm imported similar phones back from the United States and retailed them in Japan for $80. Not surprisingly, re-imports were outselling the model that never left Japan by 10 to 1. The manufacturer admonished retailers for selling lower quality export products and bought up their entire supplies of 3,000 phones at a cost of almost $250,000.[1]

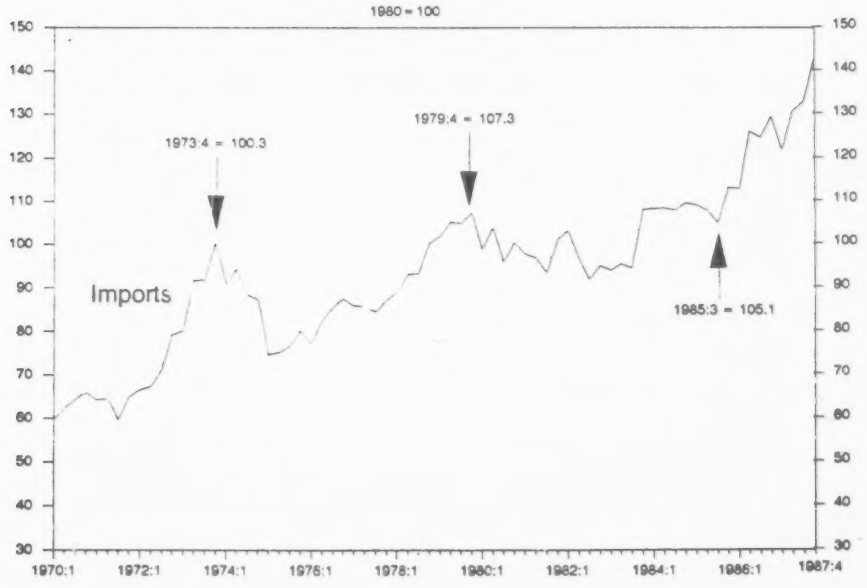
One recent study found that Japanese exporters were raising their dollar export prices far less in response to the yen's rapid appreciation since 1985 than they had done in the episode of rapid appreciation in the late 1970's.[2] The breakdown by product category suggested that export price hikes had been most restrained in products such as electronics where Japanese exporters face much more intense competition from East Asian newly industrialized countries (NIC's) than they did in the 1970's. This implies that a Japanese market more open to NIC imports would undercut some of the profits that Japanese firms now make in their home market.

[1] Fred Hiatt, "Flap over Bargain Phones Shows U.S.-Japan Differences," *Washington Post,* February 14, 1987, page K18; Damon Darlin, "Japanese Learn Thrills of Bargain Shopping from Mentors Abroad," *Wall Street Journal*, March 11, 1988.

[2] Bonnie Loopesko and Robert Johnson, "Realignment of the Yen-Dollar Exchange Rate: Aspects of the Adjustment Process in Japan," International Discussion Paper #311, Federal Reserve Board, August 1987.

In the period since 1970, Japan has increased imports rapidly only when the yen was appreciating very rapidly: 1971-1973, 1977-1979, and 1985-1988 (see Figure 25). In contrast, strong income growth and a strengthening real exchange rate during the period 1979 to 1985 brought only modest increases in imports. During this period, Japan's economy grew 27 percent in real terms. Its growth rate averaged 4.4 percent -- double the average 2.2 growth rate for OECD nations as whole.[1] Meanwhile, the trade-weighted and inflation-adjusted yen appreciated in real terms between 1979 and 1985. Such appreciation accompanied by much faster growth than the rest of the world would have caused a substantial increase in imports and a declining trade balance for most nations.

FIGURE 25
Import Volume



[1] U.S. growth averaged 2.4 percent for the period. The only significant period during which the U.S. growth exceeded Japan's came in 1983 and early 1984, when the United States was rebounding from its deepest postwar recession.

PROSPECTS FOR REDUCING THE IMBALANCES

Since the summer of 1987 the economy in Japan has been growing much faster than any other major industrial nation. National output grew at an annual rate of 7 percent in the second half of 1987 and 11 percent in the first quarter of 1988. Strong growth is projected to continue for the balance of 1988, providing a propitious situation for the government to adjust the nation's trade and investment patterns to restore international balance.

Dismantling the Japanese import barriers discussed earlier in this report would benefit Japanese consumers and speed the reduction of international imbalances. At the same time, if the government used other measures to maintain strong internal growth, the availability of, and competition from, cheaper foreign imports would raise living standards of Japanese consumers. Because import liberalization would reduce Japan's large surpluses, it would relieve pressure for further appreciation of the yen.

Experience from 1979 to 1985 indicates that surpluses continue to expand with only modest yen appreciation and no import liberalization. Moreover, rapid appreciation of the yen in 1971-1973, 1977-1978, and 1985-1988 made only modest reductions in Japanese surpluses. The destabilizing effect of rapid yen appreciation on financial markets was seen in the abrupt declines in the dollar and dollar bonds that occurred in 1987 (see Figure 14, on page 11).

Japan's domestic economy and economic policy have proved to be quite resilient as rapid yen appreciation has stalled "export-led growth" since late 1985. With investments redirected toward supplying domestic demands, high growth and low unemployment could be maintained. In particular, greater investment in housing and infrastructure has buoyed the economy since 1985 and could continue to do so for some time to come.

Externally, however, Japan has continued to give less priority to areas without commercial rewards. Among industrial nations, it ranks near the bottom in terms of the share of its resources devoted to defense and to development assistance. To the extent that Japan has provided development assistance, it has had a reputation for tying aid to purchases of Japanese exports. Japan also imports a low proportion of the manufactured exports from developing nations.

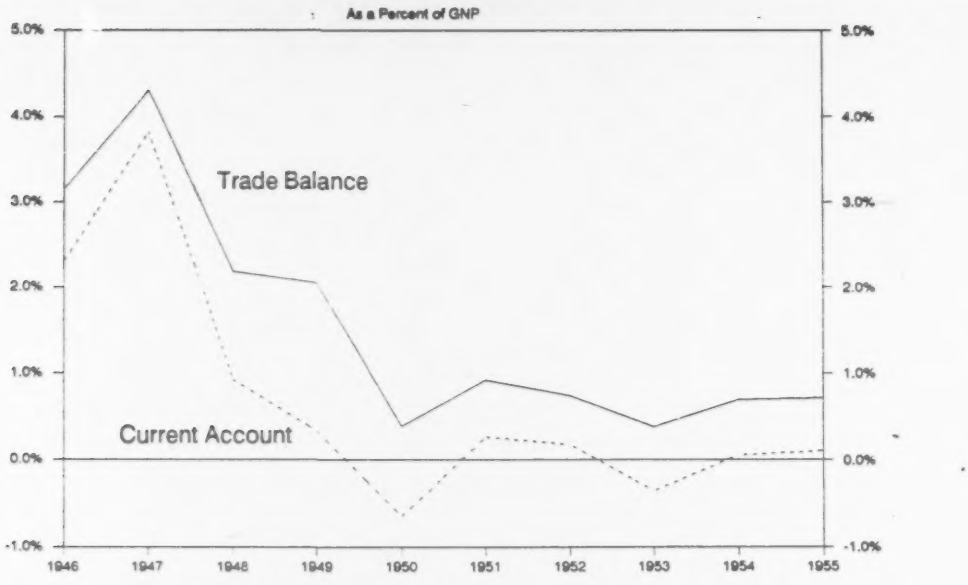
PRECEDENT FOR REDUCING LARGE SURPLUSES

With pressures mounting to make fundamental changes in the way it conducts economic policy, Japan will need to develop responses to the evolving situation. In this context, the U.S. experience four decades ago may be illuminating. While the world economy has changed fundamentally since 1945 and no nation today has the economic hegemony then possessed by the United States, it may nonetheless be useful to recall the U.S. decision to accept responsibility to promote world economic prosperity in the postwar period. It was a decision that ultimately redounded to the economic benefit of the world economy and the United States. Not only were the fears of lapsing back into a depression in the absence of war not realized, but the U.S. efforts helped launch the world economy and its own economy on a trajectory of the most rapid and sustained period of growth ever seen.

Immediately after World War II, the United States took the initiative in working with other nations to organize the United Nations, the International Bank for Reconstruction and Development (World Bank), and the IMF. The nation committed major financial resources to the Marshall Plan and to the multilateral institutions that it helped to create. It established an exchange rate regime that permitted struggling foreign nations to set values for their currencies that made them very competitive with the United States. The U.S. market was actively opened up to imports, not only with the negotiation of the GATT, but also by helping foreign producers to establish contacts and markets in the United States. In the private sector, U.S. manufacturing firms invested heavily abroad, substantially upgrading the capital stock and technology of foreign nations.

These measures had a profound effect on the U.S. trade position in the short term while laying the basis for a generation of world economic growth which benefited the United States. Between 1946 and 1951, U.S. imports doubled and the merchandise trade surplus declined from more than 3 percent of GNP to less than 1 percent. Massive unilateral transfers by the United States made the current account barely positive in 1951 (see Figure 26).

FIGURE 26
U.S. Trade Balance and Current Account



In making these commitments, the United States had practical concerns that resemble those of Japan today. In 1947, the United States had exports twice as large as imports, manufacturing capacity greater than domestic demand, and dependence on exports to markets where demand far exceeded capacity. The United States was worried about political developments in its major foreign markets where restrictions on its exports and investments were threatened. The world was beset by fears of imminent worldwide recession that would have fallen hardest on major exporters such as the United States.

The United States of the late 1940's also had some domestic economic conditions that have some parallels in Japan today. After years of restricted consumer credit, American households then had substantial savings and a strong interest in investing them in affordable housing and accompanying durable equipment. There were great unmet needs for public infrastructure. A major shift in the allocation of investment and employment was required to restore balanced economic growth. Here again, U.S. policies introduced in the late 1940's are instructive. For example, the United States provided incentives for housing construction and helped channel credit into that sector.

POLITICAL STRUCTURE AND THE MAEKAWA REPORT

Every major change in Japan's economic policies and practices proposed by informed observers has provoked strong domestic resistance. Nonetheless, in October 1985, soon after Japan agreed to join in coordinated efforts to lower the dollar relative to the yen and other currencies, Prime Minister Nakasone appointed an ad hoc commission to study medium-term and long-term policies to respond to "the recent environmental changes surrounding Japan in the international economic situation." The panel was chaired by Haruo Maekawa, former Governor of the Bank of Japan.

The Maekawa report noted the need to reduce import barriers in the areas discussed earlier in this study: agriculture, distribution, housing, infrastructure, regulatory matters, and restrictive business practices. The language of the report was the subject of major battles with the affected ministries and, perhaps as a consequence, is often ambiguous and very general. The report received positive reviews from politicians and the press abroad when it was published immediately prior to the 1986 economic summit, but the reviews in Japan itself were highly negative and the report had no immediate effect on Japanese policy.

Since then, the report has received little public or media attention in Japan. While acknowledging this, Japanese officials contend that the report has nonetheless focused debate within the government and that, unlike the first report, a substantively similar second Maekawa report in 1987 has received the endorsements of the bureaucracy in the ministries and the leadership of the Liberal Democratic Party which has controlled the parliament (Diet) since its formation in 1955.

These endorsements are crucial if major policy changes are to take place. Political power in Japan is shared by the leadership of the LDP, senior civil servants, and certain segments of business. To a degree unusual in industrial nations, Japan's civil service provides the training grounds for subsequent leaders not only in the ministries themselves, but also in the LDP and major businesses.

The recommendations of the Maekawa report would, if aggressively implemented, benefit urban consumers and export industries. The effect on urban consumers would be direct since more open trade and a more competitive distribution system should bring prices in Japan down closer to world market prices. The effect on export industries would be more indirect, but also significant. A consequence of today's large trade surpluses is the strong upward pressure that financial markets are putting on the yen, thereby forcing export industries to make painful adjustments to maintain their sales. A more open market for imports would relieve some of the upward pressure on the yen. Indeed, a significant opening of the market could allow trade balance to be restored without a higher valued yen.

Despite positive benefits to these important constituencies, the report has encountered stiff resistance from agricultural cooperatives, small retailers, wholesalers, financial institutions, construction firms, and some manufacturing firms who are the major financial backers of the LDP. Rural opposition is particularly important, since the party's voting strength is concentrated in rural areas which are disproportionately represented in the Diet.

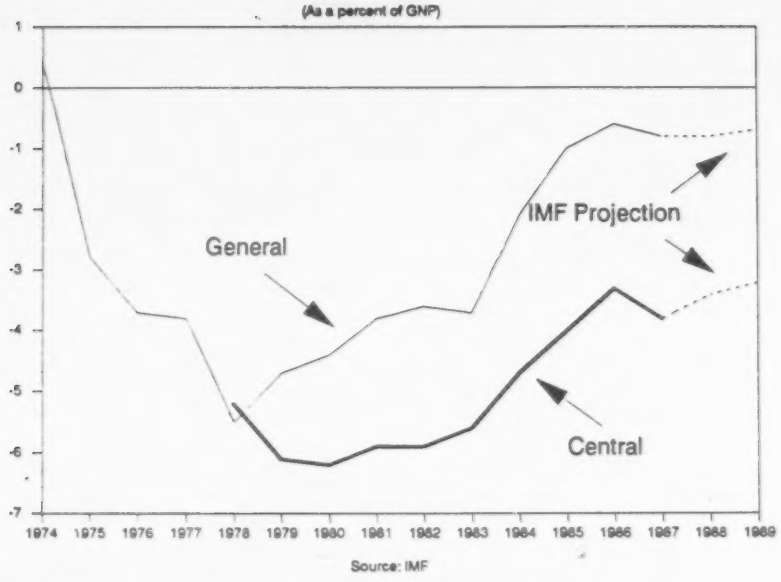
This rural bias is changing, but it is not yet clear how fast this change will be and how it will affect economic policymaking. The Japanese Supreme Court has been unwilling to require reapportionment except in instances when the populations of urban prefectures districts become very far out of line with rural ones. There is a growing understanding among the leadership of the LDP that, even at the risk of offending some major financial backers, it must do more to appeal to the "salaryman" who works in urban factories and offices. The "salaryman" now often votes for candidates of opposition parties but is coming to represent an increasing share of the electorate.

THE ROLE OF RECENT FISCAL POLICY

Japan's most recent fiscal policy has played an effective role in stabilizing the domestic economy but it has had little effect in reducing external imbalances. Earlier in the decade as the economy was propelled by export growth fiscal policy contributed to the creation of excess national savings. Budget debates during 1987 and 1988 have reflected a tension between the goals of eliminating budget deficits and maintaining growth.

Since 1979, Japan has followed a course of fiscal austerity which the government has termed "fiscal reconstruction." During this period, the deficit of the central government was reduced from 6.1 percent of GNP in 1979 to 3.3 percent in 1986 while the combined deficit for all levels of government was reduced from 4.7 percent in 1979 to 0.6 percent in 1986 (see Figure 27). Both deficit measures expanded in 1987, but are projected to resume shrinking in 1988 and 1989.

FIGURE 27
Government Deficits



Source: IMF

The official "fiscal reconstruction" goal of eliminating the deficit of the central government's general account by fiscal 1990 (ending March 1991) was recently reaffirmed by the new prime minister, Noboru Takeshita. The general account, which includes most of the budget except major construction and investment programs, still runs a deficit of roughly 2 percent of GNP.

The direction for fiscal policy under the new prime minister remains unclear. On the one hand, Mr. Takeshita served as Finance Minister during the early years of Mr. Nakasone's term when budget policy was most austere. However, he has retained Mr. Miyazawa, his successor as Finance Minister, in that post. Mr. Miyazawa has favored a more stimulative fiscal policy at least since his 1984 campaign to become prime minister and he oversaw the stimulative 1987 supplemental package.

The framework of fiscal policy is established in discussions between the LDP and the ministries in the fall of each year. The budget that emerges in December from that process is normally approved by the Diet in the spring without change. Every year since 1979, the general budget approved in the spring has reduced real spending over the last general budget. The initial budget for fiscal 1988 repeats the pattern of austere initial budgets.

The Japanese government is understandably far more concerned with maintaining strong domestic growth and low unemployment than it is with reducing external imbalances. The evolution of the 1987 budget strongly indicates the ineffectiveness of external pressure for stimulus in the absence of internal pressure and the responsiveness of Japanese fiscal policy to domestic priorities. It may give some indication of the prospects for fiscal policy in 1988. During 1986, the Japanese government had responded to foreign pressures for faster growth with assurances that the 1987 budget would be stimulative. Although there were initial attempts to defend it as such abroad, the budget for 1987 was undeniably contractionary as proposed in December 1986 and approved in May 1987.

Subsequent evidence revealed that the domestic economy was stagnating. The number of people unemployed rose by 10 percent in the first half of 1987 (see Figure 28), and growth of domestic output went to zero in the second quarter of 1987 (see Figure 29). With fears growing that the fast-rising yen might put the economy into recession, the government began work on an expansionary supplementary budget. The structure of the Japanese economy puts a high premium on avoiding recessions. Japanese companies typically rely much more on debt than equity than do companies in other industrial nations. In addition, the major companies have policies of "lifetime employment" for most of their work force. These policies have the advantage of instilling loyalty and support for labor-saving technology in good times, but effectively raise fixed costs to be carried in hard times.

FIGURE 28

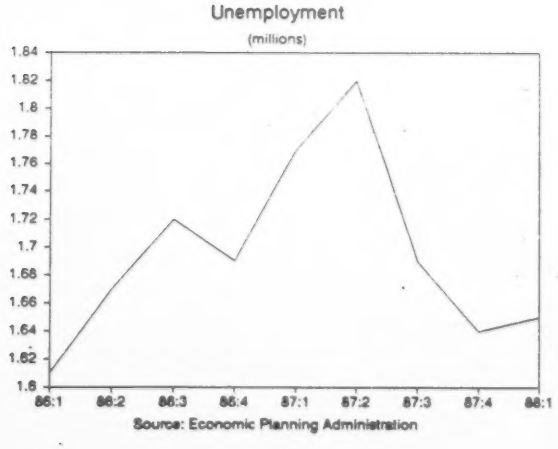
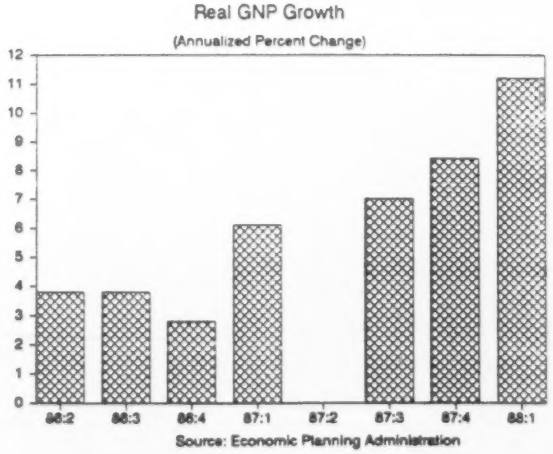


FIGURE 29



Immediately after the initial budget was approved in May, the government unveiled its supplemental budget. This two-year package of public works spending and tax cuts was quickly approved to provide new stimulus worth 1 percent of GNP each year. Two smaller supplemental budgets were approved in the fall of 1987 and early 1988. In combination with the contractionary initial budget adopted for 1987, however, even this extraordinary package resulted in only a modest net stimulus for the year (see Figure 16, on page 15).

The Japanese government, like other governments, is more sensitive to domestic political pressure than to pressure from abroad. Strong foreign political pressure failed to win an expansionary initial budget. The midyear supplemental budget was more potent than was required to placate foreign critics. In contrast, domestic political pressures for expansionary fiscal policy were mild as the initial budget was prepared in the fall of 1986. Later as exchange rate appreciation took its toll on export industries and unemployment rose in the spring of 1987, the domestic pressures grew and produced a major supplemental package.

Although the Japanese government has hailed its initial budget for fiscal 1988 as the first initial budget in many years to increase total central government spending, that does not necessarily mean a boost for the economy. In the Japanese budgetary system, "central government spending" is a term which includes both direct outlays by central government ministries and revenue-sharing transfers to the prefectures. Because of strong economic growth, central government revenues are rising quickly, as are the outlays associated with revenue-sharing. Central government ministries, on the other hand, are actually reducing their outlays, a fact masked by the expansion of revenue-sharing transfers to the prefectures. With the central government retaining its share of increased revenues but cutting its spending, the budget approved in April once again has a contractionary effect (see Figure 16, on page 15).

Unfortunately, fiscal measures alone will do little to reduce external imbalances unless they are complemented by a sufficiently strong yen and specific measures to lower barriers to imports. Indeed, although Japan has adopted the fiscal stimulus recommended by many concerned with international imbalances and although domestic growth has accelerated, the net external surplus measured in dollars has started to grow again (see Figure 3, on page 3).

REDUCTION OF IMBALANCES THROUGH IMPORT LIBERALIZATION

Recent and past experience indicates that the decline in Japan's trade surplus will depend more on trade policy and exchange rates than on the growth rate of GNP. While the level of imports will be affected by whether GNP expands at the 3.75 per-

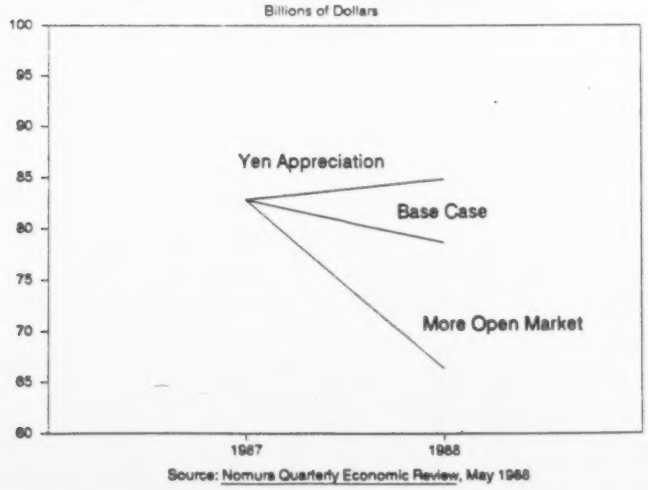
cent rate projected by the new Five Year Plan or at the 2.6 percent rate considered "recessionary" by Japan in 1986, a more significant means of reducing the surplus would be major import liberalization.

It would be possible for Japan to accelerate its growth rate and still not reduce its international imbalances. Indeed, Japan's external imbalances have expanded since the second quarter of 1987 despite rapid GNP growth. The most recent available data (through the end of 1987) show real GNP growing at an average annual rate of 8 percent for the last two quarters of 1987. That boom was led by growth rates of 28 percent in housing, 22 percent in public investment (largely public works), and 9 percent in private nonresidential investment. However, the import contribution to all three of those sectors remains quite low.

Research done by Nomura Research Institute indicates that import liberalization can be more effective in reducing the surplus than further yen appreciation. Compared to its base case with modest reductions in the surpluses, import liberalization would reduce the current account by $12 billion in fiscal 1988. In contrast, yen appreciation to 113 per dollar (instead of the base case of 123 per dollar) without import liberalization would raise the current account surplus by $6 billion because of the reverse "J-curve effect" of raising the dollar value of exports (see Figure 30).[1]

[1] *Nomura Quarterly Economic Review,* May 1988, page 13.

FIGURE 30
Scenarios for the Current Account Balance



Source: Nomura Quarterly Economic Review, May 1988

Japanese policy appears committed to sustaining strong growth and preventing an increase in unemployment. If 1987 practice is repeated in 1988, the government will adjust fiscal policy to maintain domestic growth but move slowly to take measures that reduce imbalances. Whether growth slows will depend on the interplay of conflicting trends.

On the one hand, the expansionary effects of the tax cuts and public works in the three supplemental budgets passed during fiscal 1987 probably have not entirely dissipated. On the other hand, the yen appreciated sharply again in late 1987 and, with some lag, may hurt export industries and slow the economy before the end of the year. Moreover, the pace of housing and public works is expected to slow due to pressures on land prices. Nonetheless, both are expected to be large and expanding sectors in the Japanese economy for some time. Japan could help reduce its external imbalances by permitting foreign firms greater participation in the construction industry, but it has been reluctant to do so.

Placing the focus on import liberalization rather than output growth does not mean that faster Japanese output growth is not desirable since it helps reduce external imbalances indirectly by creating jobs for workers displaced by agricultural and manufactured imports. That changes the climate to become more receptive to more imports which, in turn, reduce the surplus.

The structural resistance to reducing Japan's trade surplus can be seen by considering manufactures and nonmanufactures trade separately. Japan's $160 billion trade surplus in manufactured goods is only partially offset by its $65 billion deficit in other goods. For Japan's trade surplus to decline, either the manufactures surplus must decline or the nonmanufactures deficit must rise.

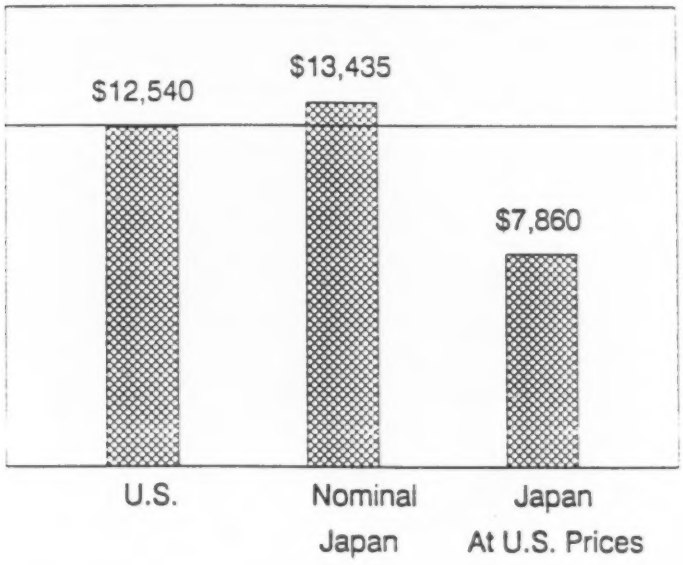
As the two oil shocks indicated, a sharp rise in commodity prices could make a dramatic change in Japan's external accounts, but such an increase is neither on the immediate horizon nor a preferred route toward external balance. Rapid growth in agricultural imports is another possibility, but past experience suggests that is unlikely.

That leaves narrowing the manufactures surplus as the remaining option which could occur as a result of some combination of further appreciation of the yen and import liberalization. Total output in manufacturing need not decline if domestic demand expands to take up the slack. However, the types of additional production demanded at home will differ somewhat from that which recedes in trade competition. If yen appreciation brings about the reduction in the surplus, losses will fall more heavily on price-sensitive export industries. To the extent that import liberalization narrows the surplus, import competing industries would bear the brunt of losses in production.

IMPORT LIBERALIZATION AND THE CONSUMER

At an exchange rate of 125 yen per dollar, Japan's GNP per capita of $23,765 runs 25 percent ahead of the U.S. level of $19,050. This does not mean that the average consumer in Japan enjoys a higher material standard of living. Because consumption accounts for 57 percent of GNP in Japan but 66 percent in the United States, per capita consumption spending is only 7 percent higher in Japan (see Figure 31).

FIGURE 31
Per Capita Consumption Spending



Although they spend 7 percent more per person in nominal terms, Japanese consumers can buy much less than Americans because they must pay much higher prices, due in large measure to import restrictions in Japan. Indeed, as noted before, the retail prices of goods made in Japan often run much higher there than in the United States, the consequence of import barriers, an inefficient distribution system, higher sales taxes, and differential pricing. The OECD estimates that prices in Japan average 70 percent higher than U.S. prices for comparable products. When higher prices in Japan are factored in to the analysis, consumption per capita in Japan is only 63 percent as high as in the United States (see Figure 31).

HOUSING AND INFRASTRUCTURE

To account for Japan's strong growth recently at the April 1988 meeting of the Group of Seven, Japanese Minister of Finance Kiichi Miyazawa explained that "Japan is really a developing country -- there is a lot we should be doing in my country in social overhead and infrastructure."[1] The Japanese have long acknowledged and been concerned about these differences. The large gap still separating Japan from other major advanced nations in their housing and public infrastructure was documented in an 1986 OECD study *Urban Policies in Japan*, initiated at the suggestion of the Japanese Ministry of Construction.

Key elements in the new Five Year Plan prepared for Prime Minister Takeshita resemble those in the one prepared for Prime Minister Tanaka before the first oil shock. Upon taking office, Prime Minister Tanaka directed the Economic Planning Agency to chart a course for major investments in public infrastructure and housing which developed into a Five Year Plan and his book *Building a New Japan*. It is widely believed in Japan that efforts in these areas were deflected by the two oil shocks of the 1970's.

Households must pay substantially more for housing in Japan than in other industrial nations despite the fact that the average floor space per home in Japan is roughly two-thirds of the norm in European nations. Policies that have long restricted the supply of land for residential use (discussed below) and credit for home ownership have held down the supply of housing and made the price of housing higher. With respect to the credit available for housing, the OECD study noted that "because a high priority has been given to industrial development in Japan, housing production has not increased in line with growth in the economy."[2]

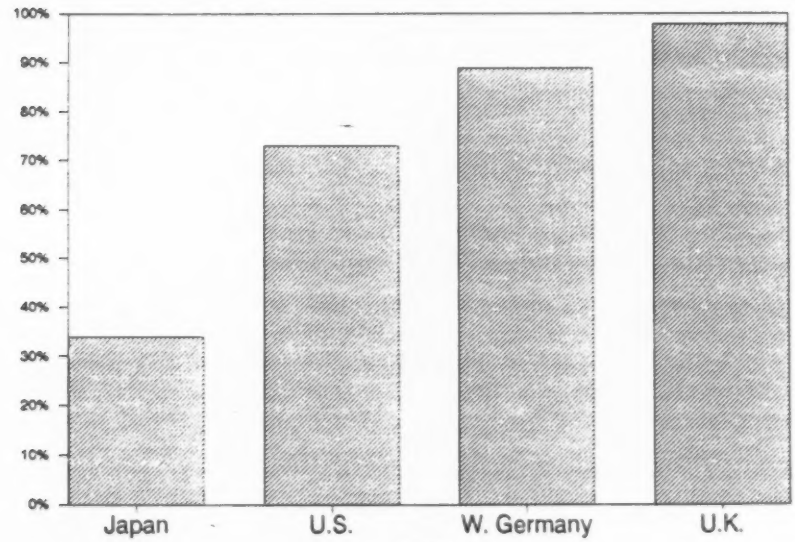
In 1983, 11.4 percent of households lived in housing that did not meet "minimum standards" and 51 percent did not meet "average standards." "Minimum standards" consisted of being equipped with toilet, washroom, bathroom for the exclusive use of the household (except for single units), and floor space per person of 230 square feet for a single person, 210 square feet for two, and 180 for three. "Average standards" also include heating, hot water supply, and 50 to 70 percent more floor space per person.

[1] Hobart Rowen, "Miyazawa: No Rush to Reduce Trade Surplus," *Washington Post*, April 17, 1988.

[2] Organization for Economic Cooperation and Development, *Urban Policies in Japan*, 1986, page 65.

In 1985, only 34 percent of Japanese homes were connected to central sewer systems. That amount is up from 6 percent in 1960, but still well below the connection rate of other major industrial nations (see Figure 32). Although the connection rate is 99 percent for Osaka and 82 percent for Tokyo, it is only 60 percent for Yokohama and 43 percent for Hiroshima.

FIGURE 32
International Comparisons of Sewer Connections



Source: OECD

Many urban housing units without sewage connections rely on cisterns which must be regularly sucked out by roving trucks. Others lack cisterns as well but may share bathroom facilities with other housing units. Although cisterns are more practical than central sewage in low density areas, they pose environmental hazards in the high density urban areas of Japan. The government has set a target of reaching the 85-90 percent connection rate typical of Europe early in the next century. The recent period of fiscal austerity has put it behind schedule. In 1982-1984, new construction of sewage lines was cut significantly. As a result, the OECD reported that Japan had hooked up only three-quarters of its target in the Five Year Plan period that ended just before its 1986 study.

Japan has a well-regarded system of interurban and intra-urban railways. The nation has nonetheless become increasingly dependent on cars and buses and its sys-

tem of roads and highways is also underdeveloped. Within urban areas, only 49 percent of roads are paved. As traffic has become more congested, bus running speeds have slowed markedly. With sidewalks along only 13 percent of urban streets, Japan has an exceptionally high rate of pedestrian traffic fatalities. Tokyo still lacks a ring road system and progress is slow in creating one.

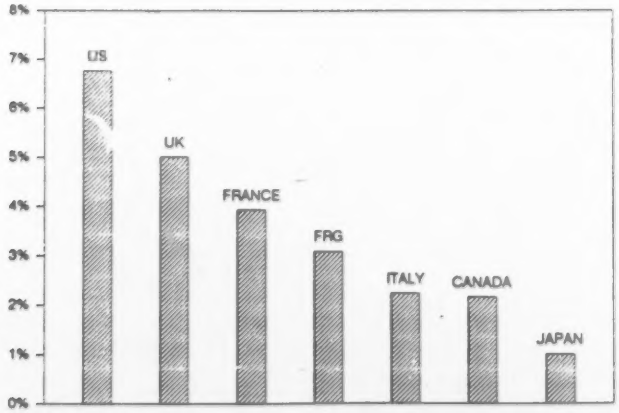
Park space is very scarce in Japan's urban areas. Tokyo has only 2 square meters of park space per capita, compared to 10 in Paris, 19 in New York, 33 in London, and 46 in Washington. The average for 11 major Japanese cities is only 3.2 square meters. Over the last 40 years, while the area of parks has remained about 3 percent of Tokyo's land area, woodland in the area has dropped from 11 percent to 3 percent.

Housing and public infrastructure take on particular importance as the population ages. Japan has a relatively low proportion of its population over age 65 today, but that will change rapidly over the next 20 years. An exceptionally large share of the population is now in the forties and fifties age group with an improving life expectancy. The changing age structure means fewer people will be at work. Since his bid for Prime Minister in 1984, the current Minister of Finance Miyazawa has emphasized that investment in housing and infrastructure should be accelerated now, while the share of the population of working age is still high.

DEFENSE-RELATED MEASURES

By widely used measures of defense costs, Japan spends roughly 1 percent of its GNP on defense compared to 6.7 percent for the United States and an average of 3.3 percent for other members of the North Atlantic Treaty Organization (NATO), as shown in Figure 33.

FIGURE 33
RATIO OF DEFENSE SPENDING TO GDP, 1986



While some have concluded that Japan should spend substantially more on defense as a way of reducing international trade imbalances, there are constraints on how much Japan can be expected to reduce imbalances with defense-related measures. Limitations on Japan's military effort derive from constitutional guidelines, consistent practice in the postwar era, and concerns of their neighbors that are unlikely to change significantly in the near term.

It should be noted that comparisons solely on the basis of percentages of GNP can be misleading. Japan's GNP is much larger than all NATO members other than the United States. With the inclusion of military pensions used in standard NATO comparisons, Japan's defense spending comes closer to one and a half percent of GNP and ranks at least sixth in the world and by some estimates third after the United States and the Soviet Union. Moreover, since its GNP has been growing faster than NATO nations, Japan's defense spending since 1981 has grown faster in real terms than that of all NATO members except the United States.

Japan inevitably spends less of its GNP on defense than other industrial nations, however, since it has a very limited defense establishment. In the 1950's and 1960's, Japan's defense spending failed to keep pace with the rapid growth of the economy, and by the mid-1960's dropped to less than 1 percent of GNP (with military pensions excluded). In 1976, the LDP made it a matter of policy to keep defense spending below 1 percent of GNP. Soon after taking office in 1982, Prime Minister Nakasone sought to change LDP policy to permit narrowly measured defense spending in excess of 1 percent. In his last year, he persuaded the party to exceed the 1 percent barrier for fiscal 1987. Defense spending that fiscal year was 1.004 percent of GNP and that adopted in the 1988 budget edges up to 1.013 percent (excluding military pensions).

Japan's Asian neighbors are extremely wary of any significant Japanese military presence beyond its territorial waters. From Korea and China through Southeast Asia and the Indonesian archipelago, there are bitter memories of conquest and occupation by Japan in the 1930's and 1940's. In recent years, the Japanese Ministry of Foreign Affairs has sponsored public opinion surveys in Southeast Asia that reveal widespread apprehension that Japan would become a "threatening military power" if encouraged to assume a greater defense role. Government leaders of these nations often caution the United States against encouraging Japan to expand its military activities beyond legitimate self-defense needs or independent of the United States. Mr. Takeshita highlighted his assurances on this point in speeches to Southeast Asian heads of state meeting in Manila in December during his first speech abroad as prime minister and in his first speech when the Diet opened in 1988.

There are ways for Japan to spend more on defense and reduce international imbalances without increasing its military forces and equipment, however. For ex-

ample, it could provide larger financial support for U.S. military efforts on its behalf. Japan's 1988 fiscal budget provides for a 10 billion yen increase in support for U.S. forces in Japan, up only 3 percent from fiscal 1987. This compares to the 5 percent increase predicted for Japan's GNP and a sizable increase in U.S. expenditures on Japan's behalf. Japan imports much of its oil from the Persian Gulf where the United States has sent additional forces at a cost of $30 million a month. In addition, the United States operates 118 military facilities in Japan where it stations some 46,000 Americans and employs thousands of Japanese. U.S. costs in Japan have risen as the yen-dollar exchange rate has doubled over the last few years.

As another possibility, Japan could do considerably more to reduce the trade imbalance and yet spend less on defense. Japan could pay half as much for imported military aircraft as it now pays for virtually identical aircraft produced domestically under license from U.S. companies. The government is willing to pay the additional cost because it hopes that its aerospace companies can learn the latest technology from the U.S. companies. Ongoing discussions with the United States about the new FSX fighter plane suggest that Japan once again intends to have as much as possible produced in Japan, thereby spending more money per plane and avoiding balance-correcting imports.

ASSISTANCE TO THIRD WORLD GROWTH

Economic assistance appears to offer a promising path for Japan to put its economic surpluses to work for the advantage of the world trading system. Polls in recent years have shown that 75 percent of the Japanese public supports the ongoing level of foreign aid. However, Japan spends less than 0.3 percent of GNP on official development aid which exceeds the U.S. percentage but is well below the other OECD nations. Japanese officials have recently decided to increase development aid from 0.29 percent of GNP to the OECD average of 0.35 percent of GNP over five years.

Given the yen's appreciation and a modest increase in the yen budget for aid, Japanese officials predict that their aid disbursements will reach $10 billion this year and surpass those of the United States. U.S. officials emphasize that most of these disbursements will take the form of loans and that the "grant equivalent" of Japanese aid (based on grants plus the present value of the discount provided on the loans rather than the value of the principal disbursed) will still fall short of the "grant equivalent" of U.S. aid. Among OECD donor nations, Japan has the lowest share of disbursements in the form of grants.

Japan's foreign aid program has traditionally focussed on project lending that "has so far been export-oriented, aimed at increasing Japan's exports to developing na-

tions."[1] Japanese aid agencies have typically required as a condition for assistance that engineering/consultancy services be provided by firms either from Japan or a developing nation. In practice, virtually all Japanese aid has assisted projects designed by Japanese engineers. Not surprisingly, the resulting project plan details have favored equipment purchases from Japanese suppliers.

Since 1982 the question of development assistance has been overshadowed to some extent by the debt crisis in the developing world. Foreign debts are a burden on growth and development in much of the Third World where many nations are struggling to solidify newly democratic governments. The magnitude of the problem has become clear as more than 40 nations have been unable to meet their scheduled debt service payments. Despite the difficult internal adjustments which many of these nations have pursued in order to meet foreign obligations, private lending to them has declined sharply. The result has been a growing negative net resource transfer. Resources which would otherwise have been directed to domestic growth have gone instead to debt service payments, and gross capital formation and the rate of economic growth have fallen significantly.

The debt crisis in the developing world has affected the industrialized world as well, weakening financial institutions in the creditor nations and effectively shrinking what had once been important export markets for the industrialized nations. Although the crisis is now into its seventh year, there have been only unilateral and piecemeal efforts to address it.

Foreign hopes that Japan would make a major contribution to resolving this problem were heightened when the Japanese government announced a Third World debt proposal in April 1987. Japan said it would recycle $30 billion of its current account surplus into untied assistance to developing nations over three years. It appears that, in fact, this Third World lending plan fails to deliver as much as initial news reports would suggest. Although specific details of the plan have yet to be made public, enough is known to raise questions about how much the plan will expand growth in the most debt-burdened nations.

Of the total, $10 billion represents funds previously committed to the World Bank, IMF, Asian Development Bank, and other multilateral development banks (MDB's). Another $8 billion is attributed to Japan's giving the MDB's permission to

[1] Shoji Ochi, Deputy President, Japan Center for International Finance, a private banks' research institution, quoted in Sumio Kido, "Development Aid Increase to Showcase Global Policy," *Japan Economic Journal*, May 28, 1988, page 6.

borrow funds in the Tokyo capital market. That is only fractionally above the annual level at which Japan has been permitting the MDB's to borrow for several years.

Of the remaining $12 billion, $9 billion is slated for co-financing arrangements with World Bank projects. Those loans could come from Japanese private banks or one of two government agencies, the Japanese ExIm Bank (JEXIM) or the Overseas Economic Cooperation Fund (OECF). The private banks and JEXIM would provide loans only on commercial terms and only after the World Bank has certified a project as justified. JEXIM regulations also require that the borrowing nation have a standby IMF arrangement. There are probably not many borrowers who could meet such conditions but who would be unable to borrow on commercial terms in the absence of the Japanese program.

The final $3 billion will be lent by the OECF bilaterally over three years. That amount does not represent new money since the OECF had already been budgeted at that level in previously approved budget plans. It is not clear how much of this lending will have below-market interest rates and how far below it will be. In the past, concessionary terms have been provided primarily to the International Development Agency (IDA) nations (those considered the poorest by the World Bank) which would exclude the major Latin American debtor nations.

In summary, the proposal for a $30 billion program over three years seems a very small improvement over previous policy for a nation which runs such large annual trade and current account surpluses. The current program may also be of little benefit to the major debtor nations, since most of the major debtors are in Latin America, but only $2 billion has been slated for Latin America.

The failure of these and other piecemeal efforts to resolve the problem suggests the need for a more concerted, comprehensive approach, involving a multilateral framework for reducing and restructuring the debt of heavily indebted developing nations. A debt facility could provide such a framework. Tying debt reduction to a debtor nation's policy reform, the facility would purchase debt at a discount from the commercial banks and pass the discount along to the borrower in the form of restructured repayment obligations. Since developing nations' loans are already being discounted on world secondary markets, the facility would help to regularize a process already underway and ensure that the discount is passed through to the debtor nation.

In this regard, at the Economic Summit meeting in Toronto in June 1988, the Japanese government offered a new proposal for an IMF role in factoring commercial loans to the most debt burdened nations. This proposal was apparently first raised with the governments of other summit nations only a few days before the summit and was

not adopted. However, it is noteworthy as an indication of an emerging Japanese willingness to play a more assertive role in international economic policymaking.

Japan could also use its current surplus position to contribute to growth in the Third World by buying more manufactured imports from there. According to the most recent data compiled by the GATT, Japan imported only $10.5 billion in manufactured goods from developing nations, less than one-seventh as much as the United States (see Figure 34). This is particularly striking since some of the most competitive manufacturers in the Third World are geographically much closer to Japan than to the United States. Since 1985, imports from East Asian developing nations have been increasing at more rapid rates from very low levels. However, MITI analyses indicate that the bulk of new imports have been arranged by Japanese manufacturing firms seeking profits to offset exchange rate-related losses. Thus, import growth could slow if exchange rates stabilize.

FIGURE 34
Total Manufactured Imports from Developing Countries

Source: General Agreement on Tariffs and Trade

THE ROAD AHEAD

Japan today has the world's largest surpluses of trade and savings and the second largest market. Japan has been slow to recognize that a nation of such size strongly influences world economic health, to its own and everybody else's long-term gain or loss. Pursuing its own commercial goals, Japan has contributed to world growth and prosperity by supplying innovative products at competitive prices. In the 1980's in particular, as the United States has borrowed heavily from abroad, Japan's surpluses have provided a flow of savings to the world economy. However, it is clear that current imbalances cannot be continued indefinitely and that the health of the world economy will require a redirection of effort.

Today, no major national economy can long stay immune to changes in the world economy. For the first half of the 1980's, U.S. imports rose rapidly and spurred growth in the rest of the world. Japan's export industries benefited more than most. Now that the U.S. economy appears to be on a course of reducing its net imports of manufactures, world economic growth faces new threats: lack of demand rather than a lack of savings; and financial instability stemming from international imbalances. Japan can significantly contribute to reducing both threats by increasing its imports on a sustained basis, particularly through import liberalization.

Rapid growth alone has not ensured declining external balances in the last year nor, in periods of more stable exchange rates, a sustained rise in imports. Fundamental reforms to liberalize the treatment of imports appear necessary for Japan to maintain import growth and to approach external balance without further substantial yen appreciation. In addition, Japan can do more to assist the defense efforts of its political and economic friends despite the severe constitutional limitations at home and political constraints abroad. Finally, as the world's largest creditor and source of new lending, Japan can well afford to provide relief to indebted developing nations whose growth is being stunted by external debt burdens. Those developing nations and others would also benefit from greater opportunities to export into the Japanese market.

APPENDIX ONE: TRADE GAINS FOR JAPAN AND LOSSES FOR THE UNITED STATES, 1979-1985

A large portion of Japan's trading gains up to 1985 were won at the expense of U.S. producers, either in the U.S. market or in third country markets lost by U.S. exporters. According to Japanese trade data, the trade surplus with the United States increased by $33 billion, over half of the overall trade balance improvement of $57 billion (see Table A). With its exports to the United States rising by 150 percent, Japan's dependence on the U.S. market rose sharply from 26 percent of its exports in 1979 to 37 percent in 1985.

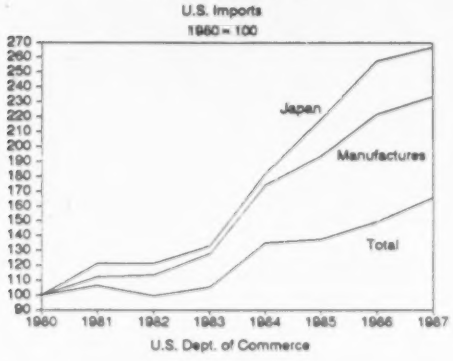
Table A

Japan's Trade With World and United States,
Total and Manufacturing, Billions of Dollars

	1979	1985	Change
Total			
World			
Exports	101.9	176.0	74.1
Imports	109.0	125.8	16.8
Balance	-7.1	50.2	57.3
U.S			
Exports	26.0	64.7	38.7
Imports	20.3	26.3	6.0
Balance	5.7	38.4	32.7
Manufactures			
World			
Exports	99.6	173.4	73.8
Imports	27.1	36.4	9.3
Balance	72.5	137.0	64.5
U.S.			
Exports	25.7	64.2	38.5
Imports	8.5	13.6	5.1
Balance	18.2	50.6	32.4

Japan fared much better in the U.S. market than did the rest of the world taken together. Between 1980 and 1985, U.S. imports from the rest of the world rose 29 percent overall while imports from Japan rose 120 percent (see Figure 35).

FIGURE 35



In the expanding markets outside the United States, Japanese exporters found better opportunities as U.S. exports receded. From 1980 to 1985, the volume of U.S. manufactures exports eroded 18 percent, the equivalent of $37 billion.in lost exports for 1985. During that same period, Japan's exports to the rest of the world grew by $35 billion, in part by winning some of those lost U.S. export sales and in part by growing with the world market.

Overall U.S. exports to Japan, as measured in current dollars, fared little better than those to the rest of the world from 1979 to 1985 despite the facts that the Japanese economy was growing much faster than other markets and that the yen depreciated much less than other currencies. U.S. exports to Japan rose from $18 billion to $23 billion, while exports to the rest of the world increased from $182 billion to $213 billion. There are no volume measures of U.S. exports on a country basis, but reasonable estimates suggest that U.S. export volume to Japan was roughly constant through the period.

Japan benefited disproportionately from the decline in the U.S. trade balance over the period 1979 to 1985. If U.S. imports from Japan had risen only as much as imports from the rest of the world and exports to Japan as little as exports elsewhere, the U.S. deficit with Japan would have risen to $16 billion in 1985 instead of the $50 billion that occurred.

APPENDIX TWO: DROP IN EXPORT PRICES RELATIVE TO HOME PRICES

Indexes developed by the IMF suggest that a relatively closed domestic market assists Japanese manufacturers in maintaining their export markets. Figure 36 charts three indices that each adjust the nominal trade-weighted yen value with a different relative cost or price factor. The index adjusted for unit labor costs reflects the cost of production in Japan relative to its trade competitors; the one adjusted for wholesale prices reflects the relative price of goods sold in Japan; and that adjusted for export unit values reflects the relative price of goods exported from Japan.

FIGURE 36
Trends in Export and Domestic Prices

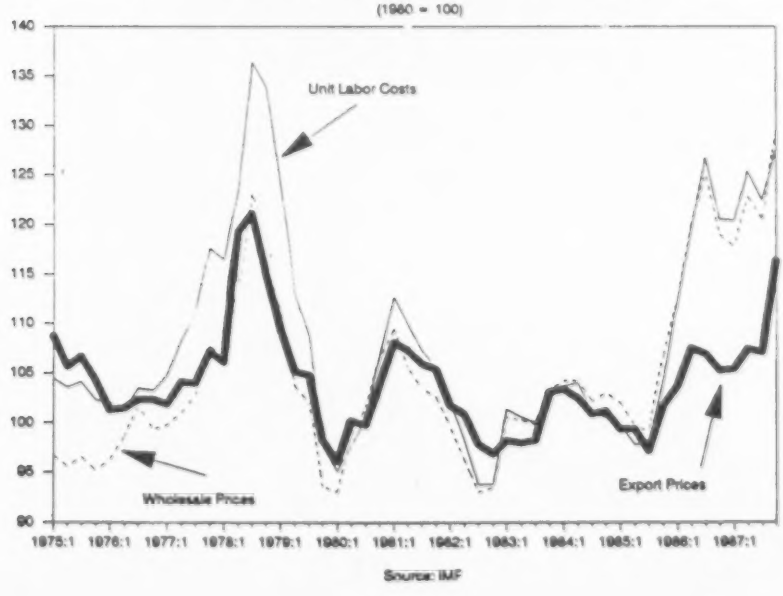


Table B compares the change in these three indices during two periods of rapid yen appreciation, from the first quarter of 1977 to the third quarter of 1978 and from the first quarter of 1985 to the last quarter of 1987.

Table B
Increase in Index Values

Index	1977:1-1978:3	1985:1-1987:4
Unit labor cost adjusted	30.2%	31.9%
Wholesale price adjusted	23.3	30.2
Export price adjusted	18.8	19.6

In a world of free markets and competitive pricing, export prices and domestic wholesale prices would track fairly closely. That did not occur in either period, although the divergence has been much wider in the recent period: relative wholesale prices rose 4.5 points more than exports in the first period but 10.6 points more in the second.

The rapid appreciation of the yen in both periods lowered the cost of inputs imported into Japan relative to the cost of Japanese labor. If producers pass these lower costs on to their customers, wholesale and export prices rise less than unit labor costs. In fact, during the recent period, wholesale prices have almost entirely matched unit labor cost increases. This suggests that Japanese manufacturers have not been passing on import cost savings fully to Japanese customers. At the same time, export prices have risen much less than either unit labor costs or wholesale prices. The gap between the unit labor cost index and export price index appears too wide to explain by cheaper imported inputs alone. The profits made from keeping the gains from cheaper imports and not passing them on to domestic customers may be subsidizing lower prices on exports.

Analysis done by the Ministry of International Trade and Industry indicates an even wider discrepancy between domestic prices and export prices since 1985. It shows that domestic prices have risen more than domestic input prices over the last three years while export prices have fallen by more than 10 percent relative to domestic input prices.[1]

[1] Ministry of International Trade and Industry, *The 1988 White Paper on International Trade* (summary in English), June 7, 1988, Figure 15.